Investment Management Regulatory Update

June 28, 2018

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SEC Modernizes the Delivery of Fund Reports and Seeks Public Feedback on Improving Fund Disclosure and Fees Related to Forwarding Fund Materials

On June 4, 2018, the Securities and Exchange Commission (the “**SEC**”) adopted new Rule 30e-3 under the Investment Company Act of 1940 (the “**Investment Company Act**”). According to the adopting release (the “**Adopting Release**”) and subject to certain conditions described below, new Rule 30e-3 allows registered investment companies, including certain registered unit investment trusts, to satisfy their obligations under the Investment Company Act to deliver shareholder reports through an optional “notice and access” method. The SEC issued a proposing release on June 12, 2015 (the “**Proposing Release**”), containing Rule 30e-3 as part of the SEC’s broader Investment Company Reporting Modernization proposal, though the final rules were adopted in 2016 without Rule 30e-3. For further discussion of the adoption of the Investment Company Reporting Modernization rules, please see the **October 31, 2016 Investment Management Regulatory Update**.

According to a press release announcing the new rule (the “**Press Release**”), Rule 30e-3 is part of a long-term project by the Division of Investment Management to modernize the design, delivery, and content of fund disclosures. SEC Chairman Jay Clayton noted in a published statement that while Rule 30e-3 will allow investors to more easily search, hyperlink, and otherwise interact with a document, the optional method also reduces expenses associated with printing and delivering shareholder reports, which are ultimately borne by the funds’ investors. Additionally, he noted that “since [2015], the

Commission has benefitted from robust public comment and engagement from a diverse group of interested parties" regarding Rule 30e-3.

The Adopting Release notes that Rule 30e-3 allows a fund to deliver its shareholder reports by making the reports accessible on a specified publicly accessible website, provided that a paper notice providing, among other things, instructions on accessing the reports, has been sent to investors. Rule 30e-3 also provides protections to investors who want to continue to receive paper copies of shareholder reports. Reliance on Rule 30e-3 is optional and is conditioned upon the following requirements:

- Extended Transition Period – According to the Adopting Release, funds may rely on the new rule beginning no earlier than January 1, 2021. If relying on the rule before January 1, 2022, a fund must provide prominent disclosures on the cover page or beginning of its summary prospectuses, statutory prospectus, and annual and semiannual reports for two years during the period between January 1, 2019 and December 31, 2021. Additionally, funds that newly offer shares between January 1, 2019 and December 31, 2020, but include the notice disclosure in the relevant documents beginning from the date of their first public offering, are allowed to rely on the rule beginning on January 1, 2021. For funds that begin offering shares publicly on January 1, 2021 and thereafter, the funds would not be subject to this requirement and "could therefore rely on the rule immediately without providing any advance notice through required statements." These disclosures will provide key information regarding a fund's intent to rely on the rule and an overview of the rule's operation.

- Notice – Investors must receive a paper notice of the availability of electronic shareholder reports within 70 days after the end of the period covered by the report. The notice must be written in "plain English," contain a prominent legend stating that an important report is available online, state that the report includes a list of portfolio holdings and the fund's financial statements, include a phone number to contact the fund or financial intermediary and contain instructions for where investors can access the report online and how investors can request paper copies. In addition to specific required disclosures in the notice, it may also include additional information, including email addresses for investors to contact the fund or its intermediaries, as well as certain content from the shareholder report. If the notice does include additional information from the shareholder report, such notice must be filed with the SEC as part of a fund's report on Form N-CSR. The Adopting Release notes that if performance information is included, "all information required with respect to the particular performance item in accordance with applicable presentation requirements" is also required to be included. Rule 30e-3 also permits one notice to be sent to shareholders who share an address, so long as current SEC householding requirements are met. Additionally, the notice may accompany other materials, including a shareholder's account statement. The Adopting Release further notes that, in contrast to the Proposing Release, there is no requirement to list the URLs for each individual report or to include a reply card with a postage stamp for investors to indicate their choice of paper or electronic reports.

- Shareholder Election – At any time, investors may elect to receive paper copies, or electronic copies (via e-mail), of all reports by calling a toll-free telephone number or otherwise notifying the fund or intermediary. An investor's preference need only be communicated once. An investor may also request free paper copies of any particular report on an ad hoc basis. If an investor requests paper copies of reports, such reports must be transmitted to the investor, at no cost to such investor, within three business days after the request is received.

- Report Accessibility – In relying upon the rule, the shareholder report and a fund's most recent prior report must be accessible free of charge at a publicly accessible website. Additionally, the Adopting Release notes that the website address used cannot be the SEC's electronic filing system, but does not require the website be maintained by any particular party. Additionally, the website provided must "be specific enough to lead investors directly to the documents that are required to be accessible under the [rule]." The Adopting Release also notes that Rule 30e-3 contains a safe harbor provision allowing funds to continue relying on the rule even if they did not satisfy the posting condition for a temporary period of time, presuming that the funds have "reasonable procedures in place to ensure that the required materials are posted on the specified website in the manner required by the rule and take prompt action to correct noncompliance with [the] posting requirements."

- Format – Materials required to be posted on a publicly accessible website must be formatted in a way that is convenient for reading online and printing on paper, and persons accessing the materials must be able to permanently retain an electronic copy of the materials.
- Availability of Quarterly Holdings – If a report required to be posted includes a summary schedule of investments, the fund's complete portfolio holdings as of the close of the covered period must also be made available at the specified website, along with the complete portfolio holdings as of the close of the fund's most recent first and third fiscal quarters, within 60 days after the close of that period. The holdings must be presented in the manner prescribed by the SEC.

The Adopting Release also notes that a fund relying on Rule 30e-1(d), which allows mutual funds to transmit a copy of its prospectus or statement of additional information in lieu of a shareholder report, could not rely on Rule 30e-3. Additionally, Rule 30e-3 provides that if an investor has notified a fund complex or unit investment trust that it wishes to receive paper copies of shareholder reports, "the investor will be deemed to have requested paper copies with respect to (i) any and all current and future funds held through an account or accounts with (A) the fund's transfer agent or principal underwriter or agent thereof for the same 'group of related investment companies' (as such term is defined in rule 0-10 under the Investment Company Act); or (B) a financial intermediary; and (ii) any and all funds held currently and in the future in a separate account funding a variable annuity or variable life insurance contract." The Adopting Release also notes that the SEC is adopting related amendments to certain rules and forms to conform to Rule 30e-3's requirements.

The Adopting Release also contains guidance related to how the conditions and requirements of the rule may apply in the context of investors holding fund shares through financial intermediaries. The Adopting Release goes on to note that financial intermediaries "already perform many functions similar to those outlined in rule 30e-3," including forwarding a variety of materials from funds (including shareholder reports) and issuers of securities to beneficial owners, as well as operating websites that host shareholder reports and other materials.

"The new rule significantly modernizes delivery options for fund information while preserving the right of fund investors to receive information in paper form as they do today," said SEC Chairman Jay Clayton in the Press Release. "I look forward to public feedback on next steps, and encourage everyone with an interest in fund disclosure—especially Main Street investors—to give us their ideas on how to improve the design, delivery and content of fund disclosures."

In addition to the adoption of Rule 30e-3, the SEC also issued two requests for comment on other matters related to the modernization of fund disclosures:

- Request for Comment on Enhancing Fund Disclosure to Improve the Investor Experience – The first request (the "**Disclosure Request**") seeks comments from mutual fund, exchange-traded fund and other types of investment fund investors on how to improve the design, delivery and content of fund disclosure in order to "improve the investor experience and to help investors make more informed investment decisions." The Disclosure Request notes that "[d]isclosure is the backbone of the federal securities laws and is a principal tool" used by the SEC to protect investors. The Disclosure Request also specifically seeks input on how to utilize technology to improve, modernize fund, and personalize fund disclosure.

- Request for Comment on Processing Fees Intermediaries Charge for Forwarding Fund Materials – The second request (the "**Fee Request**") seeks public comments on the current framework under which broker-dealers and other intermediaries may charge fees for distributing "certain non-proxy disclosure materials to fund investors, such as shareholder reports and prospectuses." The Fee Request notes that the New York Stock Exchange and other self-regulatory organizations are allowed, under their respective rules, to seek reimbursement for expenses for forwarding shareholder reports and other fund materials to investors "that are beneficial owners of shares held in 'street name' through the intermediary."

- ▶ **See a copy of the Press Release**
- ▶ **See a copy of the Adopting Release**
- ▶ **See a copy of the Disclosure Request**
- ▶ **See a copy of the Fee Request**

SEC Proposes FAIR Act Rules to Promote Research Reports on Investment Funds

In a May 23, 2018 release (the "**Proposing Release**"), the SEC proposed Rule 139b ("**Rule 139b**") under the Securities Act of 1933 (the "**Securities Act**"), Rule 24b-4 ("**Rule 24b-4**") under the Investment Company Act and a conforming amendment (the "**Proposed Amendment**") to Rule 101 of Regulation M ("**Rule 101**") under the Securities Exchange Act of 1934 (the "**Exchange Act**"), as directed by Congress pursuant to the Fair Access to Investment Research Act of 2017 (the "**FAIR Act**").

According to the Proposing Release, the FAIR Act directed the SEC to expand Rule 139's existing safe harbor to cover research reports on investment funds "upon such terms, conditions, or requirements as the Commission may determine necessary or appropriate in the public interest, for the protection of investors, and for the promotion of capital formation." Rule 139 currently allows the publication or distribution of research reports concerning one or more issuers by a broker-dealer participating in a registered offering of one of the covered issuer's securities. The Proposing Release notes that under the current rule, subject to certain conditions, a broker-dealer's publication or distribution of research reports are deemed not to constitute an offer for sale or offer to sell for purposes of Sections 2(a)(10) and 5(c) of the Securities Act. However, as the Proposing Release states, Rule 139's safe harbor is currently not available for a broker-dealer's publication or distribution of research reports related to specific registered investment companies or business development companies.

The Proposing Release notes that Rule 139b would establish a safe harbor for the publication or distribution of "covered investment fund research reports" by unaffiliated broker-dealers participating in a securities offering of the "covered investment fund." Similar to the existing Rule 139 safe harbor applicable to research reports about other issuers or their securities, if the conditions of Rule 139b are satisfied, such research reports would be deemed not to constitute an offer to sell the covered investment fund's securities for purposes of Sections 2(a)(10) and 5(c) of the Securities Act. According to the Proposing Release, the new safe harbor would be available even if the broker-dealer is participating in a registered offering of the covered investment fund's securities.

The Proposing Release states that Rule 139b would define "covered investment fund" to include registered investment companies, business development companies and certain other commodity or currency based trusts or funds. Under both the FAIR Act and Rule 139b, the definition of a "covered investment fund research report" includes "a research report published or distributed by a broker or dealer about a covered investment fund or any securities issued by the covered investment fund." According to the Proposing Release, the definition excludes a research report published or distributed by (i) the covered investment fund or any affiliate of the covered investment fund, or (ii) a broker-dealer that is an investment adviser, or an affiliated person of an investment adviser, for the covered investment fund.

Rule 139b would adopt the definition of "research report" used in Rule 139, which is a "written communication, as defined in Rule 405 [under the Securities Act], that includes information, opinions or recommendations with respect to securities of an issuer or an analysis of a security or an issuer, whether or not it provides information reasonably sufficient upon which to base an investment decision."

According to the Proposing Release, similar to Rule 139, Rule 139b would impose certain conditions for both issuer-specific research reports and industry research reports that must be satisfied in order to rely on the safe harbor. The Proposing Release states that such conditions are intended to "mitigate the risk of research reports being used to circumvent the prospectus requirements of the Securities Act." The Proposing Release notes that the conditions in Rule 139b are intended to track those in Rule 139 "to the extent practicable" and to deviate from Rule 139's conditions only where necessary to be consistent with the directives of the FAIR Act.

Issuer-Specific Research Reports

- *Reporting History and Timeliness Requirements*: According to the Proposing Release, the covered investment fund in an issuer-specific research report would be required (i) to have been subject to relevant reporting requirements under the Investment Company Act and/or the Exchange Act to file certain periodic reports for at least twelve calendar months prior to the broker-dealer's reliance on Rule 139b, and (ii) to have filed the requisite periodic reports in a timely manner during the preceding twelve calendar months, both of which are consistent with Rule 139.
- *Minimum Public Market Value Requirement*: According to the Proposing Release, the aggregate market value of a covered investment fund, or, in the case of a registered open-end investment company (other than an exchange-traded fund), the net asset value, would be required to be at least $75 million. The Proposing Release states that both aggregate market value and net asset value would be calculated net of the value of shares held by affiliates. The Proposing Release further notes that the public market value requirement "is designed to protect investors by excluding research reports on covered investment funds with a relatively small amount of total assets, and hence a limited market following."
- *Regular-Course-of-Business Requirement*: According to the Proposing Release, the broker-dealer would be required to publish or distribute research reports in the "regular course of business." In the case of research reports about a covered investment fund that does not have a class of securities in "substantially continuous distribution," Rule 139b would impose the additional requirement that the publication or distribution must not be the initiation of publication of research reports about the covered investment fund or its securities, or the reinitiation of such publication following a discontinuation of publication. The Proposing Release states that the test of whether a class of securities is in "substantially continuous distribution" would be based on a facts and circumstances analysis. The Proposing Release also notes that the "regular course of business" requirement is intended to "reduce the potential that covered investment fund research reports will be used to circumvent the prospectus requirements of the Securities Act."

Industry Research Reports

- *Reporting Requirement*: According to the Proposing Release, each covered investment fund included in an industry research report would be required to be subject to the reporting requirements of Section 30 of the Investment Company Act, or, if the fund is not a registered investment company, then to the reporting requirements of Section 13 or Section 15(d) of the Exchange Act. Unlike for issuer-specific reports, there would be no twelve-month reporting history requirement. The Proposing Release notes that this reporting requirement "helps assure that there is publicly available information about the relevant issuers and that investors are able to use such information in making their investment decisions."

- *Regular-Course-of-Business Requirement*: According to the Proposing Release, the broker-dealer would be required to publish or distribute research reports in the regular course of its business. For research reports regarding a covered investment fund that does not have a class of securities in substantially continuous distribution, the broker-dealer would also be required to include similar information, in similar reports, about the issuer covered in the industry report (or its securities) at the time the broker-dealer publishes or distributes the industry research report.
- *Content Requirements*: According to the Proposing Release, industry research reports would be required to contain either: (i) similar information about a "substantial number of covered investment fund issuers of the same type or investment focus," or (ii) a comprehensive list of covered investment fund securities currently recommended by the broker-dealer, but excluding any covered investment fund issuer that is an affiliate of the broker-dealer or for which the broker-dealer is an investment adviser (or an affiliate of an investment adviser).
- *Presentation Requirement*: According to the Proposing Release, analysis of any covered investment fund issuer or its securities in an industry research report could not be given "materially greater space or prominence" in the publication than that given to any other covered investment fund issuer (or its securities).

Additionally, the Proposing Release further discusses the implications of Rule 139b on certain other statutory provisions of the Securities Act and the Investment Company Act. The Proposing Release also notes that Rule 139b is not exclusive and does not affect the availability of any other exemption or exclusion from Section 2(a)(10) or 5(c) of the Securities Act that may be available to a broker-dealer, including those provided by Rules 137, 138 and 139. The Proposing Release also notes that all covered investment fund research reports under the proposed safe harbor would remain subject to the antifraud provisions of the federal securities laws.

The Proposing Release also proposed Rule 24b-4 under the Investment Company Act, which would exclude covered investment fund research reports from the filing requirements of Section 24(b) of the Investment Company Act (or the rules and regulations thereunder), except to the extent that such reports are otherwise not subject to content standards in self-regulatory organization ("**SRO**") rules related to research reports, including those contained in the rules governing communications with the public regarding investment companies or substantially similar standards. According to the Proposing Release, Rule 24b-4 "would have the effect of reducing the filing requirements currently applicable to certain communications that…would now be deemed 'covered investment fund research reports.'" The Proposing Release discusses that the FAIR Act does not explicitly reference specific content standards in SRO rules, but that such content standards would include those articulated in FINRA rules 2210, 2241(c)(1) and 2242(c)(2). Under Rule 24b-4, covered investment fund research reports under Rule 139b that would otherwise be subject to Section 24(b) would not be subject to that section "as long as they remain subject to the general content standards of FINRA rule 2210(d)(1) (or substantially similar SRO rules)." The Proposing Release notes that under the FAIR Act's rules of construction, the FAIR Act may not be construed as limiting the authority of an SRO to require filing of communications with the public if the purpose of such communications "is not to provide research and analysis of covered investment funds." Thus, Rule 24b-4 would not affect FINRA's authority to require the filing of communications that are included in the definition of "covered investment fund research report" but whose purpose is not to provide research and analysis.

In addition, the Proposing Release announced the Proposed Amendment to Rule 101 of Regulation M, which is "intended to align the treatment of research under proposed [R]ule 139b with the treatment of research under Rules 138 and 139 for purposes of Regulation M." Rule 101 prohibits "any person who participates in a distribution from attempting to induce others to purchase securities covered by the rule during a specific period," but provides an exception for certain research activities if the conditions of Rule 138 or Rule 139 are satisfied. The Proposed Amendment would change the exception in Rule 101(b)(1) of Regulation M to allow broker-dealers to publish or disseminate any information, opinion or recommendation related to a covered security if the conditions of Rule 139b are satisfied.

The Proposing Release requests interested parties to submit comments to the SEC on the proposed new rules and conforming amendment.

- ▸ **See a copy of the Proposing Release**

SEC Updates Its Custody Rule FAQs

In June, the SEC staff updated its Frequently Asked Questions with respect to Rule 206(4)-2 (the "**Custody Rule**") under the Investment Advisers Act of 1940 (the "**Advisers Act**"). This update provides that if an investment adviser does not have a copy of its client's custodial agreement and does not know, or have reason to know, whether the custodial agreement would cause the investment adviser to have custody he or she otherwise did not intend to have ("**Inadvertent Custody**"), then, as long as the only basis for custody is Inadvertent Custody, the investment adviser does not have to comply with the Custody Rule with respect to that client's account. In addition, the investment adviser would not need to indicate in its Form ADV that it has custody of such client's assets. Such relief, however, would not apply if the investment adviser recommends, requests or requires a client's custodian.

- ▸ **See the updated Custody Rule FAQs**

Industry Update

Commissioner Hester M. Peirce Outlines Enforcement Philosophy, Criticizes "Broken Windows" Enforcement

On May 11, 2018, SEC Commissioner Hester M. Peirce presented a speech entitled "The Why Behind the No," at the 50th Annual Rocky Mountain Securities Conference in Denver, Colorado. Commissioner Peirce framed her speech as a reaction to a recent article suggesting that she votes against recommendations from the SEC's Enforcement Division 15 percent of the time—a rate higher than that of any other Commissioner—and an effort to "help explain the why behind my no's."[1] Her speech presents an extended synthesis of a number of fundamental debates regarding the SEC's approach to enforcement, including whether a "broken windows" approach overemphasizes enforcement, the proper balance between the SEC's regulatory and enforcement roles, the proper focus of enforcement actions, and whether prior enforcement policies have risked creating perverse incentives and imposed too great a cost on regulated entities and their personnel.

Critique of "Broken Windows" Enforcement: "The Danger of Playing to the Numbers"

Commissioner Peirce criticized the SEC's prior "broken windows" approach to enforcement as prioritizing the number of investigations over the quality of investigations, emphasizing enforcement over the SEC's other regulatory goals, and imposing too great a cost on the SEC and its regulated entities. During the "Broken Windows" era—which she identified as running roughly from 2013 to 2016—she suggested the SEC "should have changed its name to the 'Sanctions' and Exchange Commission," having "acted like a branch of the U.S. Attorney's Office for the Southern District of New York," and having had an "enforcement-first" approach that led SEC staff to recommend enforcement over other regulatory tools. Among the consequences of this approach, in Commissioner Peirce's view, are discouraging an open

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[1] Andrew Ramonas and Jennifer Bennett, SEC's Newest Republican Emerges as One-Woman Party of 'No', *Bloomberg Law*, May 7, 2018, *available at* **https://www.bna.com/secs-newest-republican-n57982092578/**

dialogue between the SEC and regulated entities, leading companies to avoid becoming public issuers for fear of exposing themselves to SEC enforcement, and imposing too great costs on innocent or non-culpable parties who were subject to enforcement investigations.

Prioritizing the SEC's Role as Regulator

A second major theme of Commissioner Peirce's speech is that the SEC should use all regulatory tools at its disposal rather than prioritizing enforcement. As an initial example, Commissioner Peirce described the Office of Compliance Inspections and Examinations ("**OCIE**") as "one of our most valuable tools," as OCIE can help firms apply the SEC's rules and regulations to the firm's specific business and identify areas for improvement. She contrasted OCIE's role in facilitating compliance with treating OCIE as "an investigative arm of the Enforcement Division," and noted that in "most instances" OCIE should be able to resolve matters without a referral to Enforcement. Similarly, Commissioner Peirce suggested that the SEC should address recurring situations or regulatory gaps through formal rulemaking, as opposed to either "rulemaking by enforcement," which may be "faster and more convenient" but not in keeping with the spirit of the Constitution and the Administrative Procedure Act, or by using settlements to extend the SEC's authority beyond that provided by statute or rule. She noted that SEC settlements are often treated as a form of common-law precedent. She strongly questioned whether the SEC should use settlements to create law, as in her view, a "settlement negotiated by someone desperate to end an investigation that is disrupting or destroying her life should not form the basis on which the law applicable to others is based."

Avoiding Undue Collateral Consequences and Perverse Incentives

A final theme of the speech is that overemphasis on enforcement actions risks imposing too great a cost on regulated entities and creating perverse incentives for SEC staff and regulated entity personnel. She noted that a focus on imposing sanctions on corporations for wrongdoing of corporate officers effectively punishes corporate shareholders—the victims of the original wrongdoing—by forcing them to bear both the costs of the wrongdoing and the penalty imposed. SEC staff may also be incentivized to pursue higher-value enforcement actions with less impact on the public interest—she provided the example of a "large-dollar violation that occurs in the context of a transaction between two sophisticated financial institutions"—rather than lower-value cases of more importance to protecting retail investors, such as cases involving Ponzi schemes or affinity frauds. Similarly, SEC staff may keep moribund investigations open for extended periods of time for "fear of missing something or appearing to have too light an enforcement touch," imposing unnecessary costs and disruption on the subjects of investigations. The result of these costs and incentives, she noted, may be to disrupt a productive dialogue between regulated entities and the SEC. She singled out chief compliance officers ("**CCOs**") as bearing the brunt of these effects, as their job is to "advocate for compliance" and "monitor for violations." Accordingly, the "Commission must take great care in imposing liability", as accepting firms' attempt to "lay blame at the feet of a CCO who was trying her best", discourages "good CCOs." Commissioner Peirce notes, "otherwise, who will want to serve in these jobs"?

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It is too early to assess whether the SEC's shift away from a "broken windows" approach has resulted in a meaningful shift in the tone of regulated entities' relationship with the SEC or in the risks and incentives posed by SEC enforcement. Indeed, some of Commissioner Peirce's statements—in particular regarding the role of OCIE exams—appear somewhat contrary to apparent settlement trends. However, against the background of lively debate regarding the appropriate role and emphasis on enforcement in the SEC's regulatory agenda, Commissioner Peirce's speech may be welcome evidence that the SEC is continually assessing the effects of its announced policy focus and actively balancing competing regulatory priorities.

- **See a transcript of the speech**

Share Class Selection Initiative Update: SEC Deadline Passes for Investment Advisers to Self-Report Under the Share Class Selection Disclosure Initiative

The deadline for investment advisers to notify the SEC's Division of Enforcement (the "**Division**") that they intend to self-report under the Share Class Selection Disclosure Initiative (the "**SCSD Initiative**") passed on June 12, 2018. The SCSD Initiative encouraged investment advisers that have failed to make required disclosures to clients about conflicts of interest associated with receipt of 12b-1 fees to notify the Division of those failures in exchange for the Commission's recommendation of favorable settlement terms. For further discussion of the SCSD Initiative, please see the March 15, 2018 Davis Polk Client Memorandum, **SEC Announces Self-Reporting Initiative for Rule 12b-1 Disclosures**. The success of the SCSD Initiative will become more clear in the coming months.

Following the announcement of the SCSD Initiative on February 12, 2018, the Division announced substantial settlements with three investment advisers for breaching fiduciary duties to clients and substantially profiting off improper 12b-1 fees.[2] The relevant SEC orders state that PNC Investments LLC, Securities America Advisors, Inc., and Geneos Wealth Management, Inc. each failed to disclose the conflict of interest created by investing advisory clients in higher-cost mutual fund share classes with 12b-1 fees when lower cost-share classes of the same funds without the 12b-1 fees were available.[3] As part of the settlement, these firms reimbursed their advisory clients a total of $12 million in 12b-1 fees and prejudgment interest, and agreed to pay civil monetary penalties ranging from $250,000 to $900,000. The SEC announcement "encourage[ing] eligible firms to participate in the recently announced Share Class Selection Disclosure Initiative" emphasized the Division's commitment to addressing share class selection issues and the highlighted the risk of greater penalties for advisers that did not self-report.[4]

Earlier in May, the Division published a list of Frequently Asked Questions (the "**FAQs**") clarifying some terms of the Initiative and underscoring that the self-reporting deadline was unlikely to be extended.[5] For further discussion of the FAQs, please see the **May 31, 2018 Davis Polk Client Investment Management Regulatory Update**. Accompanying the May 1, 2018 release of the FAQs, Dabney O'Riordan, Co-Chief of the Division's Asset Management Unit, observed, "It appears that many investment advisers are working diligently to evaluate whether they can take advantage of the initiative and we believe that providing these FAQs will help them make that determination."[6]

Even though the self-reporting deadline has now passed, SEC Chairman Jay Clayton has noted that "it is still the early days of this initiative."[7] The SEC has declined to comment on how many investment advisers have self-reported. Recognizing Chairman Clayton has signaled that work is still being done under the initiative after the notification deadline and because the Division would still be reviewing and making

[2] U.S. Sec. and Exch. Comm'n, SEC Orders Three Investment Advisers to Pay $12 Million to Harmed Clients, Press Release 2018-62 (Apr. 6, 2018), available at **https://www.sec.gov/news/press-release/2018-62**.

[3] In the Matter of PNC Investments LLC, Release No. 4878 (Apr. 6, 2018), available at https://www.sec.gov/litigation/admin/2018/34-83004.pdf; In the Matter of Securities America Advisors, Inc., Release No. 4876 (Apr. 6, 2018), available at https://www.sec.gov/litigation/admin/2018/ia-4876.pdf; In the Matter of Geneos Wealth Management, Inc., Release No. 4877 (Apr. 6, 2018), available at **https://www.sec.gov/litigation/admin/2018/34-83003.pdf**.

[4] U.S. Sec. and Exch. Comm'n, SEC Orders Three Investment Advisers to Pay $12 Million to Harmed Clients, Press Release 2018-62 (Apr. 6, 2018), available at **https://www.sec.gov/news/press-release/2018-62**.

[5] U.S. Sec. and Exch. Comm'n, Share Class Selection Disclosure Initiative – FAQs, available at **https://www.sec.gov/enforce/educationhelpguidesfaqs/share-class-selection-disclosure-initiative-faqs**.

[6] U.S. Sec. and Exch. Comm'n, SEC Enforcement Division Issues FAQs for Share Class Selection Disclosure Initiative, Press Release 2018-75 (May 1, 2018) available at **https://www.sec.gov/news/press-release/2018-75**.

[7] Jay Clayton, Remarks to the SEC Investor Advisory Committee (June 14, 2018), available at **https://www.sec.gov/news/public-statement/clayton-statement-investor-advisory-committee-061418**.

recommendations regarding recently completed questionnaires, some settlement announcements may be forthcoming.

While the Division's success in encouraging firms to self-report remains to be seen, the SEC considers the SCSD Initiative a necessary solution to leverage limited resources to increase accountability and strengthen investor protections.[8] Reiterating the focus on misconduct that harms retail investors, Chairman Clayton stated that the SCSD Initiative reflects the Division's continuing efforts "to expose widespread misconduct in the investment advisor industry while, at the same time, quickly and efficiently compensating harmed investors."[9] Those efforts to address conflicts of interest and enhance investor protection will remain a focus of investment adviser examinations and, more broadly, of this administration regardless of the SCSD Initiative's ultimate effectiveness.

Litigation

SEC Charges Thirteen Private Fund Advisers for Repeated Filing Failures

On June 1, 2018, the SEC issued orders (the "**Orders**") against thirteen registered investment advisers (the "**Advisers**") instituting and settling administrative and cease-and-desist proceedings for each adviser's repeated failure to provide required information on Form PF that the SEC uses to, among other things, monitor risk.

According to the Orders, the Advisers were delinquent in their filings of annual reports on Form PF, which inform the SEC about the private funds they advise, including the amount of assets under management, fund strategy, fund performance and the use of borrowed money and derivatives.

According to the Orders, the Advisers were all registered investment advisers that, over multi-year periods, failed to promptly file a report on Form PF. According to the Orders, registered advisers are required to file an updated report on Form PF at least annually. The Orders note that Form PF was designed to "provide the Financial Stability Oversight Council with information important to its understanding and monitoring of systemic risk in the private fund industry," and the information collected on Form PF is used by the SEC "in its regulatory programs, including examinations, investigations and investor protection efforts relating to private fund advisers."

According to the Orders, as a result of the conduct described above, the Advisers willfully violated Rule 204(b)-1 of the Advisers Act, which requires investment advisers registered (or required to be registered) under Section 203 of the Advisers Act that act as advisers to private funds with assets of at least $150 million to complete and file reports on Form PF and periodic updates thereto with the SEC.

The Advisers consented to the entry of the Orders without admitting or denying the findings and agreed to be censured, to cease and desist, and to pay a civil money penalty in the amount of $75,000 each.

- **See a copy of the press release announcing the settlements**

[8] Stephanie Avakian and Steven Peikin, House Financial Services Committee Hearing Subcommittee on Capital Markets, Securities, and Investments (May 16, 2018).

[9] Jay Clayton, Testimony on "Oversight of the U.S. Securities and Exchange Commission" (June 21, 2018), available at **https://www.sec.gov/news/testimony/testimony-oversight-us-securities-and-exchange-commission#_ftn35**.

SEC Charges Fund Administrator for Flawed Valuation of Affiliated Unregistered Fund

On April 26, 2018, the SEC issued an order (the "**SEI Order**") instituting and settling administrative cease-and-desist proceedings against SEI Investments Global Funds Services ("**SEI**"), a fund administrator, for causing an affiliated fund to violate the Investment Company Act and rules thereunder.

According to the SEI Order, SEI acted as fund administrator for SEI Liquidity Fund, L.P., (the "**Liquidity Fund**") an unregistered money market fund that was used as a collateral investment pool for a securities lending program for certain other funds affiliated with SEI. SEI endeavored to operate the Liquidity Fund as a money market fund in order to rely on an exemption provided by Rule 12d1-1 under the Investment Company Act, including by maintaining a stable NAV of $1.00 per share under Rules 2a-7 under the Investment Company Act. The Liquidity Fund was also required to comply with, among others, Section 18 of the Investment Company Act in order to rely on the Rule 12d1-1 exemption.

In July 2008, the Liquidity Fund's shadow price dropped below $0.995 per share, leading the fund's adviser to switch to a floating market-based NAV. Because the fund's structure posed "challenges" in implementing a floating NAV, SEI is alleged to have booked purchases of Liquidity Fund shares at a fixed $1.00 per share NAV, and maintained a "side spreadsheet" to allocate losses to the various SEI funds that were investors in the Liquidity Fund. The SEC alleges that the "side spreadsheet" did not accurately reflect the investment returns had the floating NAV been used, with the result that certain funds were improperly misallocated approximately $13.8 million of losses.

The SEI Order also alleges that SEI "effectively created a second share class" in the Liquidity Fund by attempting to insulate later investors in the Liquidity Fund from the losses the fund sustained in July 2008. SEI did so by booking a fund's July 2009 investment in the Liquidity Fund at a stable NAV of $1.00, and immediately allocating to that fund losses on the side spreadsheet SEI maintained to reconcile the booked NAV of $1.00 with the fund's floating NAV. However, because this caused the fund to incur losses immediately upon investment, SEI attempted to resolve the misallocation of losses by creating a system to segregate investments in the fund from July 2009 onwards from earlier interests, and to allocate losses only to the older investors. The SEC alleged that SEI thus effectively created a class of "senior securities" of the Liquidity Fund in violation of Section 18 of the Investment Company Act.

Since the Liquidity Fund did not comply with Rule 2a-7 under the Investment Company Act or Section 18 of the Investment Company Act, it could not rely on the exemption provided by Rule 12d1-1, which caused the Liquidity Fund to violate Sections 17(a)(1) and 17(a)(2) under the Investment Company Act, which make it unlawful, absent an exemption, for any affiliated person or promoter of or principal underwriter for a registered investment company, or any affiliated person of such person, promoter, or principal underwriter, acting as principal (1) knowingly to sell any security or other property to such registered company or to any company controlled by such registered company, or (2) knowingly to purchase from such registered company, or from any company controlled by such registered company, any security or other property.

Without admitting or denying the findings, SEI agreed to accept an order that it cease and desist from violations of the Investment Company Act and pay a civil monetary penalty of $225,000.

- **See a copy of the SEI Order**

SEC Charges Broker-Dealer for Failing to File Suspicious Activity Reports in Connection with Sale of Penny Stocks

On May 16, 2018, the SEC issued orders (the "**Chardan Orders**") instituting and settling administrative and cease-and-desist proceedings against Chardan Capital Markets, LLC ("**Chardan**"), a New York-based registered broker-dealer, Jerard Basmagy ("**Basmagy**"), its former Chief Compliance Officer and Anti-Money Laundering ("**AML**") Officer, and Industrial and Commercial Bank of China Financial Services LLC ("ICBC"), its clearing firm, for Chardan's failure to file Suspicious Activity Reports ("**SAR**" or "**SARs**") when Chardan had reason to suspect that certain penny stock transactions it executed on behalf of its clients involved fraudulent activity or had no business or apparent lawful purpose.

According to the Chardan Orders, Chardan repeatedly ignored its own AML policies when it failed to file SARs despite suspicious sales of billions of penny stock shares. Chardan's AML policies stated that it would file SARs "for transactions that may be indicative of money laundering activity" including "heavy trading in low-priced securities" and "trading that constitutes a substantial portion of all trading for the day in a particular security." Despite clear instances of both, Chardan failed to initiate the internal reviews or SAR filings that its own policies mandated when presented with such suspicious activity. Chardan's own AML policies specifically charged its Chief Compliance Officer ("**CCO**") and AML Officer—Basmagy—to investigate red flags, monitor trading patterns, and file SARs. For example, the Chardan Orders describe an instance in which Basmagy, dissatisfied with the documentation provided by a customer, blocked that customer from executing a trade, but then failed to file a SAR or conduct any further investigation on the transaction. The SEC found that Chardan failed to conduct adequate investigation or to file a SAR even after ICBC brought suspicious transactions to Chardan's attention. According to the Chardan Orders, from at least October 1, 2013 through June 30, 2014, seven of Chardan's customers sold over 12.5 billion shares of thinly traded penny stocks. In June 2014, ICBC refused to continue trading in penny stock securities by Chardan customers due to concerns over these transactions. Even after its clearing firm refused to continue serving in this role, Chardan failed to investigate its customers' trading activity or file an SAR related to any of the trading that raised concerns.

As a result of the conduct described above, the SEC alleged that Chardan and ICBC willfully violated Section 17(a) of the Exchange Act and Rule 17a-8 thereunder, which require registered broker-dealers to comply with the reporting, record-keeping and record retention requirements of the Bank Secrecy Act, and that Basmagy aided and abetted Chardan's violations. The SEC also separately alleged that ICBC violated Section 17(a) of the Exchange Act and Rule 17a-4(j) thereunder by failing to maintain and produce certain records relating to the investigation in response to an SEC request.

Without admitting or denying the findings, Chardan consented to entry of the cease-and-desist order and a censure, and agreed to pay a civil monetary penalty of $1 million. Basmagy consented to entry of a cease-and-desist order, a three-year bar from association with any broker, dealer, or investment adviser (among other entities), a three-year bar from participating in any offering of penny stocks and $15,000 in civil penalties. ICBC consented to a cease-and-desist order, a censure and a civil penalty of $860,000.

Two aspects of the Chardan Orders stand out: First, the SEC chose to pursue enforcement action against Basmagy for aiding and abetting Chardan's failures, even though the orders do not detail why Basmagy did not cause Chardan to file the SARs, or whether specific failures on Basmagy's part led the SEC to pursue enforcement action against him as well as against Chardan. The Chardan Orders thus do not give guidance to CCOs on the circumstances in which the SEC will conclude a CCO has been an active participant in wrongdoing—as here, an aider and abettor—rather than simply having been unable to stop wrongdoing under the CCO's watch. Second, ICBC was charged with violating Section 17(a) of the Exchange Act for its protracted delay in producing documents that the SEC requested in August 2015 but did not receive until November 2016. This underscores the importance of timely, complete, and accurate responses to enforcement requests.

- **See a copy of the Chardan Order**
- **See a copy of the ICBC Order**
- **See a copy of the Basmagy Order**

Lyxor Asset Management, a New York-Based Investment Adviser, Settles SEC Charges for Failing to Disclose Conflict of Interest

On June 4, 2018, the SEC issued an order (the "**Lyxor Order**") instituting and settling administrative and cease-and-desist proceedings against Lyxor Asset Management ("**Lyxor**"), a New York-based investment adviser, for allegedly failing to disclose a conflict of interest surrounding its receipt of fees from two affiliated third-party advisers with whom it placed client assets for investment.

According to the Lyxor Order, Lyxor entered into an agreement with two affiliated third-party investment advisers that called for them to make payments to Lyxor based on the total amount of client assets that Lyxor placed or maintained in funds advised by the third-party advisers. The SEC alleged that Lyxor had initially attempted to negotiate an economic benefit for its clients in early drafts of the agreements with the third-party investment advisers. But, after the advisers would not agree, Lyxor accepted a final version of the agreement that called for payments to be made directly to Lyxor. According to the SEC, pursuant to the agreement, Lyxor was entitled to receive $910,469, of which $647,738 was ultimately paid in fees from July 2012 through September 2014. The SEC claimed that Lyxor failed to disclose the agreement or the payments, which were in contravention of investment management agreements with two of Lyxor's clients. The SEC further claimed that Lyxor lacked policies and procedures reasonably designed to detect and prevent such conflicts, and failed to account on its books and records for the amounts owed and ultimately paid.

The Lyxor Order noted that, following an examination by the staff of OCIE, Lyxor undertook a review and identified the funds it received from the third-party investment advisers. According to the Lyxor Order, Lyxor notified its clients, and rebated them the amount of those funds, plus interest. Lyxor then undertook a review of its agreements with other outside managers to ensure no similar agreements existed and took steps to enhance its policies and procedures.

As a result of the conduct described above, the SEC alleged that Lyxor willfully violated Section 206(2) of the Advisers Act, which prohibits an investment adviser from engaging in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client. Additionally, the SEC further alleged that Lyxor willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-7 promulgated thereunder by failing to implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules. Finally, the SEC alleged that Lyxor willfully violated Section 204(a) of the Advisers Act, and Rule 204-2(a)(2) promulgated thereunder, which requires that investment advisers registered with the Commission maintain and preserve certain books and records.

Without admitting or denying the findings in the SEC's order, Lyxor consented to the entry of a cease-and-desist order and a censure, and agreed to pay a civil penalty of $500,000.

The Lyxor Order is yet another example of an SEC enforcement settlement arising out of undisclosed actual or potential conflicts of interest created when an investment adviser receives fees, payments, or other financial incentives from third parties involved in managing client assets.

- **See a copy of the Lyxor Order**

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