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June 28, 2018

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Rules and Regulations

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 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

[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/**

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"?

* * *

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**

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**

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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