Investment Management Regulatory Update

August 30, 2018

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Rules and Regulations

SEC Rejects Proposed Rule Change for Bitcoin ETF

In an order issued on July 26, 2018 (the "**Order**"), the Securities and Exchange Commission (the "**SEC**") disapproved a rule change proposed by Bats BZX Exchange, Inc. ("**BZX**") to list and trade shares ("**Shares**") of the Winklevoss Bitcoin Trust (the "**Trust**"). The Order notes that the Trust would hold only bitcoins as an asset and the bitcoins would be in the custody of and secured by the Trust's custodian, Gemini Trust Company LLC; the Trust's investment objective would be for Shares to track the price of bitcoin on the Gemini Exchange, a digital-asset exchange owned by the Gemini Trust Company. According to the Order, BZX initially filed the proposed rule change (the "**Proposal**") in June 2016, which the SEC disapproved in March 2017 (the "**March Disapproval Order**"). BZX then petitioned for review of the March Disapproval Order, and the SEC reviewed the Proposal de novo after seeking public comment. The Order states that the SEC again rejected the Proposal, as BZX did not meet its burden under the Securities Exchange Act of 1934 (the "**Exchange Act**") and the SEC's Rules of Practice to demonstrate that the Proposal is consistent with Section 6(b)(5) of the Exchange Act, which according to the Order, requires that rules of a national securities exchange be "designed to prevent fraudulent and manipulative acts and practices" and "to protect investors and the public interest."

According to the Order, BZX's appeal of the March Disapproval Order presented several arguments in support of its petition, including, among others, that: (i) the Proposal is consistent with Section 6(b)(5) on the grounds that the bitcoin market is less susceptible to manipulation than equity, fixed income and

commodity futures markets, in part because the "geographically diverse and continuous nature of bitcoin trading makes it difficult and prohibitively costly to manipulate the price of bitcoin" and because "novel systems intrinsic to this new market provide unique additional protections that are unavailable in traditional commodity markets"; (ii) the March Disapproval Order did not adequately appreciate that the Proposal includes "traditional means of identifying and deterring fraud and manipulation" and satisfies criteria the SEC has applied in approving other commodity-trust exchange-traded products ("**ETPs**") regarding "the ability to monitor for, detect, and deter fraud and manipulation"; and (iii) the March Disapproval Order overstated "the extent to which surveillance and regulation of the underlying market have been present in prior commodity-trust ETP approval orders and the extent to which the [SEC] has relied on the existence of surveillance-sharing agreements between an ETP listing market and markets related to the underlying assets." Additionally, the Order noted that, under the SEC's Rules of Practice, the burden is placed on the self-regulatory organization to "demonstrate that a proposed rule change is consistent with the Exchange Act and the rules and regulations issued thereunder. . . ."

The Order stated that the SEC rejected BZX's argument that "intrinsic properties of bitcoin and bitcoin markets" provide inherent resistance to manipulation. The Order stated that BZX "has not demonstrated that the structure of the spot market for bitcoin is uniquely resistant to manipulation." In support of this finding, the Order cited various comment letters, academic studies and the risk factors disclosed in the Trust's registration statement, which suggest that bitcoin spot markets are as susceptible to fraud and manipulation, if not more so, as other markets. For example, the Order notes that the Trust's registration statement acknowledges that bitcoin trading venues have been attacked by hackers, "which can affect liquidity and result in volatile prices," in addition to the risk of malicious actors obtaining control of the processing power dedicated to mining on the bitcoin network and exerting authority over it, which could lead to pricing manipulation.

In addition, according to the Order, the record does not support BZX's assertion that existing traditional means of identifying and deterring fraud and manipulation are sufficient to satisfy the requirements of Section 6(b)(5). The Order stated that "BZX has not demonstrated, given the current absence of a surveillance-sharing agreement with a regulated bitcoin market of significant size, that the alternative surveillance procedures BZX purports to identify—including BZX's assertion that it would be able to obtain certain information regarding trading in the Shares and in the underlying bitcoin or any bitcoin derivative—would be sufficient to satisfy" the requirements of Section 6(b)(5). For example, the Order noted that pursuant to BZX's listing rules, it would only be able to obtain information regarding trading in Shares and in the underlying bitcoin or any bitcoin derivative through registered market makers for members that are registered with BZX as market makers in the Shares and not for all BZX market participants.

Furthermore, the Order affirmed that the SEC has "long recognized the importance of comprehensive surveillance-sharing agreements to detect and deter fraudulent and manipulative activity" and rejected BZX's argument that it has satisfied the requirements of Section 6(b)(5) by entering into such a surveillance-sharing agreement with the Gemini Exchange. The Order noted that although surveillance-sharing agreements are not the exclusive means by which an ETP listing exchange can satisfy the requirements of Section 6(b)(5), such agreements are a common method for exchanges that list ETPs to satisfy such obligations. In addition, the Order discussed that, as was the case in this instance, if a listing exchange fails to demonstrate that other means to prevent fraud and manipulation are sufficient, "the listing exchange must enter into a surveillance-sharing agreement with a regulated market of significant size."

According to the Order, the SEC concluded that despite BZX's assertion to the contrary, BZX "has not established that it has entered into, or currently could enter into, a surveillance-sharing agreement with a regulated market of significant size related to bitcoin." The SEC rejected BZX's arguments that Gemini Exchange is a significant exchange in the U.S. bitcoin market, or that Gemini Exchange is a regulated market based on the fact that it is a limited liability trust company chartered by New York State and supervised by the New York State Department of Financial Services. Instead, the Order noted that

Gemini Exchange is not a significant market based on its trading volume and overall share of the bitcoin market, and Gemini Exchange is not a regulated market "comparable to a national securities exchange or to the futures exchanges that are associated with the underlying assets of the commodity-trust ETPs approved to date." Furthermore, the Order stated that based on the record presented, "BZX has not shown that any of the current trading venues in the worldwide bitcoin spot market is a regulated market."

In addition, the Order also addressed arguments regarding the protection of investors and the public interest. According to the Order, BZX argued that its ETP would protect investors and promote the public interest, in part because it "would reduce the expense, complexity, and risk of bitcoin exposure." However, the Order stated that "even if a proposed rule change would provide certain benefits to investors and the markets, the proposed rule change may still fail to meet other requirements under the Exchange Act." Thus, because BZX failed to demonstrate that bitcoin and bitcoin markets are "uniquely resistant to manipulation," or that alternative methods of detecting and preventing fraud and manipulation are sufficient, the absence of a surveillance-sharing agreement with a significant, regulated market related to bitcoin "compels the [SEC] to conclude that the [Proposal] must be disapproved" because BZX failed to demonstrate that the Proposal is consistent with Section 6(b)(5).

- **See a copy of the March Disapproval Order**
- **See a copy of the Order**

Industry Update

Commissioner Hester M. Peirce Reacts to SEC Regulation of Investment Professionals

On July 24, 2018, SEC Commissioner Hester M. Peirce presented a speech entitled "What's in a Name? Regulation Best Interest v. Fiduciary," at the NAPA DC Fly-in Forum in Washington, D.C. Commissioner Peirce framed her speech as a reaction to recent SEC regulation of broker-dealers and investment advisers. Commissioner Peirce cited studies that show investors are confused regarding (i) "the nature of the services offered by, and the standards of conduct applicable to, broker-dealers and investment advisers," and (ii) "whether their firm or financial professional is a broker-dealer or an investment adviser, or both."

Commissioner Peirce noted that the SEC recently proposed, among other things, to limit the use of the word "adviser" (or "advisor") by some broker-dealers and their registered representatives as part of a set of proposed rules and interpretations regarding the standard of conduct for broker-dealers and investment advisers when they interact with retail investors (the "**Proposal**"). For further discussion of the Proposal, please see the May 7, 2018 Davis Polk Client Memorandum, **SEC Proposes Enhanced Standards for Advice to Retail Investors**. During her speech, Commissioner Peirce addressed commenters who would have preferred that the SEC require broker-dealers to call themselves "salespeople." However, Commissioner Peirce emphasized her belief that it is "not the title someone uses, but the standard to which he is held that matters."

Commissioner Peirce noted that legalese can carry multiple meanings and retail investors do not always fully understand the legal context in which a term may be used. Commissioner Peirce stated that she worries that terms such as "fiduciary" are so oft-repeated that retail investors will simply ask whether a financial professional is a "fiduciary" and have a "false sense of reassurance." Additionally, Commissioner Peirce noted that some commenters seem to have assessed the Proposal poorly merely because the Proposal does not refer to a "fiduciary" standard, but instead to another term—"best interest." This term also gives Commissioner Peirce pause over whether retail investors actually understand what it means and whether that term will similarly lull retail investors into a false sense of security. Commissioner Peirce stated that regulators, advisers and brokers should make an effort to encourage retail investors to

understand the practical effect behind terms such as "fiduciary" and "best interest" in terms of what investment professionals are required to do and how much any such professional is charging.

Commissioner Peirce outlined the practical difference between the SEC's proposed interpretation of an adviser's fiduciary duty to its clients and the proposed best interest standard for broker-dealers. Commissioner Peirce noted that the two standards are very similar.

The Proposal requires, in addition to a broker-dealer's existing specific obligations (including suitability, best execution, and fair and reasonable compensation), that a broker-dealer who is recommending any securities transaction or investment strategy involving securities to a retail customer, "act in the best interest of the retail customer at the time the recommendation is made without placing the financial or other interest of the broker-dealer ahead of the interest of the retail customer." The Proposal does not define "best interest" but provides that the best interest requirement would be satisfied if: (i) the broker-dealer reasonably discloses, in writing to the retail investor, the "material facts relating to the scope and terms" of the broker-dealer's relationship with said investor and all material conflicts of interest that are associated with the recommendation; (ii) the broker-dealer exercises reasonable diligence, care, skill and prudence when making such recommendations; (iii) the broker-dealer "establishes, maintains and enforces written policies and procedures reasonably designed to identify and at a minimum disclose, or eliminate, all material conflicts of interest" that are associated with the broker-dealer's recommendations; and (iv) the broker-dealer "establishes, maintains and enforces written policies and procedures reasonably designed to identify and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with such recommendations."

Commissioner Peirce noted that, according to the Proposal, the fiduciary standard owed to clients by investment advisers includes a duty of care and a duty of loyalty. She further stated that the duty of care includes: (i) the duty to act and provide advice that is in the client's best interest; (ii) the duty to "seek best execution of a client's transactions where the adviser has the responsibility to select broker-dealers to execute client trades"; and (iii) the duty to provide advice and monitoring to the client "over the course of the relationship."

Commissioner Peirce noted that an adviser's duty to act in the best interest of the client is "the same as proposed in [the Proposal for broker-dealers] and includes that any advice given be suitable for the client." She further noted that the duty to seek best execution is "the same as a broker-dealer's obligation to seek best execution." Commissioner Peirce went on to state that, under the Proposal, the only difference between the duty of care owed by an investment adviser and the duty owed by broker-dealers is that "an adviser generally must provide continuous advice and monitoring at a frequency that is both in the best interest of the client and consistent with the scope of advisory services agreed upon between the investment adviser and the client." She added that broker-dealers, on the other hand, are not required to monitor a retail customer's account, "absent a contractual agreement to the contrary."

Commissioner Peirce then noted that the adviser's duty of loyalty (i) requires an adviser to put a client's interests first, (ii) prohibits an adviser from favoring itself or another client, (iii) mandates disclosure of material facts regarding the advisory relationship, and (iv) requires an advisor to disclose, or avoid at a minimum, material conflict of interests. She added that, although the Proposal does not include an explicit "duty of loyalty" with respect to broker-dealers, the Proposal requires broker-dealers to have procedures in place to "ensure disclosure of all material conflicts of interest and mitigation or elimination of any material financial conflicts of interests."

In comparing the Proposal's standard for broker-dealers (along with broker-dealers' other requirements under the securities laws) to that of an adviser's fiduciary duty (as discussed in the Proposal), Commissioner Peirce noted that broker-dealers are subject to a more stringent standard. She expressed her concern that broker-dealers will increasingly choose to become advisers that offer only fee-based accounts, and as a consequence, retail customers would likely have reduced access to "advice they receive through recommendations from broker-dealers." Commissioner Peirce emphasized that this trend is already happening and the Proposal could increase its prevalence going forward.

Instead of the "best interest" standard, Commissioner Peirce would have preferred that the new standard include a suitability standard in addition to a requirement that broker-dealers cannot put their interests ahead of the interests of their retail customers. Commissioner Peirce believes that this simpler approach would be clear and concise, but also assist with the SEC's enforcement capacities and sufficiently address concerns regarding conflicts of interest and other "practices that harm retail investors."

Commissioner Peirce next noted that "obligations should be imposed through the rule text, not through language in the rulemaking release." She further emphasized that the SEC should focus its disclosure regime on investor–friendly disclosure, as the current disclosure regime is not investor friendly, but instead aims to avoid legal liability and satisfy regulators. She concluded by requesting comments on the Form CRS (Customer or Client Relationship Summary), which is part of the Proposal, to determine whether the current proposed form is helpful to investors or whether there are more investor–friendly approaches that would be more effective.

- **See a transcript of the Speech**

SEC Launches New Fund Disclosure Website

On June 27, 2018, the Division of Investment Management's Disclosure Review and Accounting Office (the "**DRAO**") launched a new page on the SEC's website providing access to disclosure information relating to registered investment funds. The website includes links to three separate pages.

The first page, entitled "Fund Disclosure at a Glance," provides a short summary of the DRAO's responsibilities, lists the core disclosure principles and provides contact information for the DRAO.

The second page, entitled "Accounting and Disclosure Information," is intended to be an aid to those who work with, and are interested in, the law and interpretations concerning disclosure. This page provides access to various resources covering topics on which the DRAO receives frequent inquiries. These resources are categorized by topic, and readers can access them via links included on the webpage. There is also a link on this page through which readers can submit questions directly to the DRAO.

The third page, entitled "Disclosure Reference Material," contains a link to the latest "Plain English Handbook," which explains to readers "how to create clear SEC disclosure documents." This page also provides links to common fund disclosure forms, including forms N-1A, N-2, N-CEN, N-14 and Schedule 14A.

Finally, along the right-hand panel of each of the above pages, there is a section entitled "Disclosure News," which lists newly released "Accounting and Disclosure Information" articles and other recent SEC news related to fund disclosure.

- **See the Fund Disclosure Website**

Litigation

SEC Charges Investment Adviser With Mispricing Cross Trades Between Clients

On August 10, 2018, the SEC issued an order (the "**Order**") instituting and settling administrative and cease-and-desist proceedings against Hamlin Capital Management, LLC ("**Hamlin**") for engaging in cross trade transactions that resulted in undisclosed favorable treatment of certain of its advisory clients over others.

According to the Order, Hamlin is a registered investment adviser with its principal place of business in New York which had between approximately $1.5 to $4.5 billion in assets under management from 2011 to 2016. Hamlin, according to the Order, routinely engaged in cross trade transactions between two or more Hamlin client accounts between November 2011 and March 2016 where the pricing method

resulted in Hamlin's favoring of certain of its clients over others. According to the Order, when arranging cross trades, Hamlin arranged for the buy-side of the transaction to be executed at the security's bid-side indicative quotation (the "**Bid Price**") obtained for month-end valuation purposes rather than an average or midpoint price between the Bid Price and an ask-side evaluation quotation. According to the Order, this practice had the effect of favoring the purchasing clients in the transaction over the selling clients.

Additionally, according to the Order, for certain fixed income securities, Hamlin challenged the pricing broker's bid-side evaluation quotation and requested prices higher than recent trades in the secondary market. Hamlin, according to the Order, arranged for the execution of cross trades at these higher levels without providing the pricing broker adequate documentation for the basis of the challenge or undertaking any assessment to determine whether the securities were available on similar or better terms for its buying clients in the secondary market. In doing so, according to the Order, Hamlin did not seek to achieve the best price and execution for client transactions and Hamlin's buy-side advisory clients paid more than they would have paid had the securities been available for purchase in the secondary market at terms similar to prior trades.

Finally, according to the Order, Hamlin failed to adopt and implement reasonably designed policies and procedures concerning the valuation of its clients' assets and its cross trading practices. Further, Hamlin, according to the Order, misrepresented to investors the price at which cross trades would be executed in its Form ADV and did not explain that cross trades would be executed at the Bid Price.

According to the Order, as a result of the conduct described above, Hamlin willfully violated Section 206(2) of the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"), which prohibits an adviser from "engaging in any transaction, practice or course of business which operates as a fraud or deceit upon a client or prospective client," as well as Section 206(4) of the Advisers Act and Rule 206(4)-8(a)(2) thereunder, which prohibits an adviser from "engaging in any act, practice or course of business that is fraudulent, deceptive or manipulative with respect to any investor or prospective investor in a pooled investment vehicle." In addition, according to the Order, Hamlin willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which requires, among other things, registered advisers to "adopt and implement written policies reasonably designed to prevent violations, by the investment adviser and its supervised persons, of the Advisers Act and its rules." Finally, according to the Order, Hamlin willfully violated Section 207 of the Advisers Act, which makes it "unlawful for any person willfully to make any untrue statement of a material fact in any registration application or report filed with the [SEC]…or willfully to omit to state in any such application or report any material fact which is required to be stated therein."

Hamlin consented to the entry of the Order without admitting or denying the findings therein. Hamlin agreed to a censure and cease-and-desist order. Additionally, Hamlin agreed to reimburse $609,172, plus interest, to its affected clients and agreed to pay a civil money penalty of $900,000.

- **See a copy of the Order**

SEC Charges Two Investment Advisers and an Exempt Reporting Adviser for Pay-to-Play Violations

On July 10, 2018, the SEC issued orders (the "**SEC Orders**") instituting and settling administrative and cease-and-desist proceedings against two registered investment advisers, Oaktree Capital Management, L.P. ("**Oaktree**") and Sofinnova Ventures, Inc. ("**Sofinnova**"), and an exempt reporting adviser, EnCap Investments L.P. ("**EnCap**"), for violating the "pay-to-play" rule, Rule 206(4)-5 under Section 206(4) of the Advisers Act. The pay-to-play rule prohibits investment advisers, including exempt reporting advisers, from receiving compensation for providing investment advisory services to a government entity for two

years after the adviser, or any of its “covered associates” (certain executives or employees),[1] makes a campaign contribution to certain elected officials or candidates in a position to influence the selection of investment advisers to manage government client assets.

The SEC alleged that, between September 2014 and April 2016, three covered associates of Oaktree made campaign contributions to candidates for elected office in California and Rhode Island with influence over selecting investment advisers for public pension plans in those states. According to the SEC, the campaign contributions were in the amounts of $500, $1,000, and $1,400; two of these contributions were returned. Within two years after these contributions, Oaktree allegedly provided advisory services for compensation to public pension plans in those states.

With respect to Sofinnova, the SEC alleged that, in April 2014, a Sofinnova covered associate made a $2,500 campaign contribution to a candidate for elected office in Illinois with influence over selecting investment advisers for public pension plans in that state. According to the SEC, after the contribution was made, the associate sought and obtained its return. The SEC alleged that Sofinnova provided advisory services for compensation to public pension plans in the state for eight months following this contribution.

Additionally, the SEC alleged that, between September 2013 and September 2015, EnCap covered associates made campaign contributions to candidates for elected office in Texas, Wisconsin, and Indiana with influence over selecting investment advisers for public pension plans in those states. According to the SEC, the campaign contributions to these candidates totaled over $90,000. The SEC alleged that EnCap provided advisory services for compensation to public pension plans in the states within two years after the contributions.

As a result of the conduct described above, the SEC charged Oaktree, Sofinnova, and EnCap with willfully violating Section 206(4) of the Advisers Act and Rule 206(4)-5 thereunder.

Oaktree, Sofinnova, and EnCap consented to the entry of the SEC Orders without admitting or denying the findings and agreed to be censured, and to cease and desist from committing or causing any violations and any future violations of Section 206(4) of the Advisers Act and Rule 206(4)-5 thereunder. Oaktree consented to pay $100,000 in civil monetary penalties, while Sofinnova consented to pay $120,000 and EnCap consented to pay $500,000.

The SEC Orders are the second wave of SEC settlements based on violations of the pay-to-play rule. In January 2017, the SEC settled with 10 investment advisers for pay-to-play rule violations. For further discussion of the January 2017 SEC settlements, please see the **February 28, 2017 Investment Management Regulatory Update**. Of note, the SEC pursued settlements with Oaktree and Sofinnova even though in each case the total amount of covered contributions at issue was less than $3,000 and much of the contributions were returned. The size of the penalty in the EnCap case also suggests that significantly larger fines will be assessed for what the SEC views as more pervasive violations. The SEC Orders are also a clear reminder to ensure compliance with the pay-to-play rule (and associated FINRA and MSRB rules)[2] in the run-up to the 2018 primary and general elections.

- **See a copy of the Oaktree Order**
- **See a copy of the Sofinnova Order**

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[1] Covered associates may make contributions in an aggregate amount up to the pay-to-play rule’s de minimis exception, in each election, without triggering the two-year “time out” period. See Rule 206(4)-5(b)(2) (providing for a “de minimis exception” of $350 per election if the covered associate is entitled to vote for the candidate at the time of the contribution, or $150 per election for a candidate for whom the covered associate is not entitled to vote.)

[2] See FINRA Rules 2030 and 4580, FINRA CAB Rules 203 and 408; MSRB Rule G-37.

- See a copy of the EnCap Order

SEC Charges New York-based Investment Adviser for Failing to Timely Distribute Annual Audited Financial Statements

On July 17, 2018, the SEC issued an order (the "**NSR Order**") against New Silk Route Advisors, L.P. ("**NSR**"), a New York-based investment adviser, instituting and settling administrative and cease-and-desist proceedings for failing to timely distribute annual audited financial statements to the investors in the funds that NSR advised.

According to the NSR Order, NSR registered with the SEC as an investment adviser in 2012. Since that time, NSR has advised two private equity funds (collectively the "**NSR Funds**"). From 2012 through 2017, NSR had a PCAOB-registered firm conduct audits of the combined and consolidated financial statements for the NSR Funds for the fiscal years ended March 31, 2012 through March 31, 2017. Rule 206(4)-2(b)(4)(i) requires such audits to be distributed to investors within 120 days of the end of the relevant fiscal year, if an adviser is relying on the audit exception to the custody rule's surprise examination requirement. However, NSR failed to distribute the audited financial statements to the limited partners in the NSR Funds within the required time frame. Instead, such distribution was late every year, by a minimum of 6 days for the fiscal year ended March 31, 2017, and a maximum of 246 days for the fiscal year ended March 31, 2016.

Based on the conduct described above, the SEC alleged that NSR willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-2 promulgated thereunder, which require registered advisers with custody of client assets to have independent public accountants conduct surprise examinations of those client funds or securities, or, in the alternative, to have any private fund clients timely distribute annual audited financial statements to their investors. Additionally, the SEC alleged that NSR willfully violated Rule 206(4)-7, also promulgated under Section 206(4) of the Advisers Act, which requires, among other things, that a registered investment adviser adopt written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder by the adviser and its supervised persons.

NSR consented to the entry of the NSR Order 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.

- See a copy of the SEC Order

SEC Files Lawsuit Against Temenos Advisory Inc. and its Chief Executive Officer

On July 18, 2018, the SEC filed a complaint in the District of Connecticut against an investment advisory firm and its Chief Executive Officer, alleging that defendants invested $19 million of their clients' money, including elderly investors' retirement savings, in illiquid, high-risk investments and concealed commissions in violation of anti-fraud and registration provisions of the federal securities law. The lawsuit reflects the SEC's continued focus on retail investor protection and is consistent with the SEC's published list of examination priorities, which notes a particular commitment to closely reviewing investment advisors that offer services and products to senior investors and those saving for retirement.

Temenos Advisory Inc. ("**Temenos**") and George Taylor ("**Taylor**"), the firm's Chief Executive Officer and Chief Compliance Officer, are alleged to have repeatedly downplayed and hidden risks and overstated gains associated with private placement investments. By allegedly soliciting private placement investments in exchange for undisclosed commissions from the private companies, Temenos and Taylor allegedly acted as unregistered broker-dealers. The complaint alleges that Temenos and Taylor also breached their duties as investment advisers to disclose conflicts of interest, exercise reasonable care in providing investment advice, and deal with the "utmost honesty." Temenos and Taylor allegedly breached their fiduciary duties by failing to perform due diligence, failing to disclose known defects in the

investments, pushing clients to invest in securities in which the advisers had undisclosed conflicts, grossly understating risks, and overvaluing the investments so that they could charge inflated advisory fees.

The SEC alleges that, prior to 2014, Temenos and Taylor invested their clients' money in lower-risk investments. In 2014, Temenos and Taylor began steering clients to invest in four private companies, while, according to the SEC, they collected undisclosed commissions from the private companies. The SEC further alleges that Taylor falsely suggested to clients that the private placement investments had been carefully vetted when, in fact, he and Temenos had not considered even the most basic information necessary to judge risk and return potential. In addition, the SEC contends that Temenos and Taylor knowingly provided outdated and inaccurate materials to clients and made blatant misrepresentations about the companies' financial health and performance forecasts. These private placement investments were recommended to all of Temenos's investor clients who Temenos and Taylor believed had sufficient income, without any consideration for whether the inherently high-risk investments were right for any particular client.

The SEC has requested a jury trial and seeks a permanent injunction, disgorgement of ill-gotten gains plus pre-judgment interest, and civil penalties.

- **See a copy of the SEC Complaint**

SEC Settles Charges with Beverly Hills Wealth Management and Majority Owner for Improper Fees and Material Misstatements

On July 20, 2018, the SEC announced a settlement with Beverly Hills Wealth Management, LLC ("**BHWM**"), and its majority owner, Margaret Mulligan Black ("**Black**"), for their refusal to refund $131,000 in prepaid quarterly advisory fees to 63 departing clients and for alleged material misstatements made in written disclosures concerning the firm's financial condition.

Pursuant to BHWM's advisory agreements and its Form ADV, Part 2A (the "**Firm Brochure**"), clients prepay their advisory fees at the beginning of each quarter and can provide "written notice" to terminate the relationship and receive pro rata refunds of prepaid but unearned fees. In April 2016, BHWM and Black allegedly refused to recognize email as proper termination notice and instead demanded "wet signatures," or physically signed written requests, from terminating clients.

BHWM's advisory agreement required it to return unearned fees within five days following client's termination request. According to the settlement order, by July 2016, even after receiving the new termination letters with wet signatures, only 35% of unearned fees had been returned. Only in September 2016, after SEC examination staff sent a deficiency letter and enforcement staff met with BHWM, were the remainder of unearned fees returned to clients.

The SEC's order also finds that, between March 2013 and April 2018, BHWM and Black omitted material facts and made misleading statements about BHWM's financial condition. The Firm Brochure required BHWM to disclose any financial condition that is reasonably likely to impair its ability to meet a financial commitment to clients, yet BHWM and Black, who approved and signed the Firm Brochure, failed to disclose the firm's large negative net worth and default on paying principal and interest totaling $775,000, and its difficulties in meeting its operating expenses, including payroll and rent.

Without admitting or denying the SEC's findings, BHWM and Black agreed to pay $100,000 and $50,000 in civil penalties, respectively. BHWM, which still managed more than $142 million as of March 2018, agreed to cease and desist from further violations. BHWM is also required to post the settlement order prominently on its principal website for 12 months, as well as provide all existing advisory clients with a copy of the order, and correct disclosures in its Firm Brochure.

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

SEC Charges U.S. Congressman Christopher Collins and Others with Insider Trading

On August 8, 2018, the SEC announced charges against Congressman Christopher Collins, the U.S. Representative for New York's 27th Congressional District, alleging that he provided material nonpublic information about a biotechnology company, Innate Immunotherapeutics Ltd. ("**Innate**"), to his son, Cameron Collins, who traded on the information and tipped the father of his fiancée, Stephen Zarsky, who also traded on the information. In a parallel action, the U.S. Attorney's Office for the Southern District of New York announced that Congressman Collins, Cameron Collins, and Stephen Zarsky were indicted on related criminal charges.

According to the SEC, Congressman Collins, who sat on Innate's board of directors, learned of poor results of the company's clinical trial for a multiple sclerosis drug in an email from Innate's Chief Executive Officer to its board of directors while attending an event on the South Lawn of the Whitehouse. While still on the White House lawn. Congressman Collins allegedly called his son to convey the poor results within minutes after receiving the email; Cameron Collins allegedly tipped Zarsky in person later that evening. According to the SEC, after the negative clinical trial results were publicly announced days later, Innate's stock price fell by more than 92 percent, and Cameron Collins and Zarsky avoided losses of more than $700,000.

Congressman Collins held a seat on the House Energy and Commerce Committee, which has oversight over public health. The charges against him have revived calls for stricter rules about financial investments or corporate board seats held by members of Congress while they are sitting on committees with oversight of those businesses.

The SEC's complaint, filed in U.S. District Court for the Southern District of New York, charges the three defendants with violating Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, as well as Section 17(a) of the Securities Act of 1933. The complaint seeks disgorgement of ill-gotten gains plus interest, penalties, and permanent injunctions. It also seeks an officer and director bar against Congressman Collins. Congressman Collins has denied any wrongdoing.

On August 8, 2018, the SEC also announced that it settled charges against Lauren Zarsky, Cameron Collins' fiancée, and her mother, Dorothy Zarsky, for trading on the basis of material, nonpublic information. These two investors consented to entry of final judgments without admitting or denying the charges that they sold their shares of Innate based on tips they received from Congressman Collins' son.

- **See a copy of the SEC Complaint**
- **See a copy of the SEC Settlement Release**
- **See a copy of the Indictment**

SEC Charges Investment Adviser for Undisclosed Conflict of Interest

On August 20, 2018, the SEC issued an order instituting and settling administrative proceedings against an investment adviser subsidiary (the "**Adviser**") of a large financial institution (the "**Bank**"), for failing to disclose that senior Bank executives may have influenced the Adviser's consideration of whether certain investment products offered by a third party (the "**Third Party**") would be offered to the Adviser's retail advisory clients out of concern for the Bank's commercial relationship with the Third Party.

In 2012 and 2013, in exchange for certain advisory fees, the Adviser identified a variety of investment products available to the Adviser's retail clients on the Adviser's platforms. The Adviser disclosed to investors that products would be selected following due diligence on a number of factors, but did not disclose that products might be evaluated based on other business interests of the Adviser or its affiliates.

In the spring of 2012, the Third Party informed the Adviser that it was replacing the long-time portfolio manager for certain products available on the Adviser's platforms. The Adviser placed all Third Party advised products on "hold," meaning that no new accounts could invest in the products, though current

accounts could continue to do so. The Adviser also commenced a due diligence review, and, in December 2012, the Adviser's due diligence staff recommended that the products be terminated from the platform, due to the departure of the long-standing portfolio manager and the lack of comparable experience of the replacement portfolio managers. Final say on termination would be decided by the Adviser's governance committee in January 2013.

After learning that termination had been recommended, the Third Party launched a "plan of action" to prevent termination, which included, among other things, having a senior Third Party executive contact a senior Bank executive to stress the "size and importance of the relationship," and express "disappointment" and "surprise" at the termination recommendation. At this time, Bank was also seeking an active bookrunner role in connection with a registered offering by the Third Party. A Bank executive later told a Third Party executive that the governance committee's decision would be "put on hold," in order to allow the Third Party an opportunity for "additional dialogue and to fully make the case for what [the Third Party was] doing strategically." As a result, the relevant products remained "on hold" until December 2013, after which the Adviser's due diligence staff performed further diligence and determined that the products had performed similar to, and in some cases, better than, the replacement products that the Adviser's due diligence staff initially proposed.

On December 17, 2013, the governance committee removed the products from "hold." From January 2013 to December 2013, Adviser had earned approximately $4.03 million in fees associated with its advisory clients' investment in the products.

The SEC alleged that the communications between executives of the Bank and the Third Party and its affiliates were not disclosed to the governance committee or to investors. As a result, the SEC alleged that the Adviser violated Sections 206(2) (which prohibits an investment adviser from, directly or indirectly, engaging in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client) and 206(4) of the Advisers Act and Rule 206(4)-7 thereunder (which require investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act and the rules thereunder). Adviser agreed to cease and desist from committing or causing any violations and any future violations of Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-7 promulgated thereunder, pay approximately $4.03 million in disgorgement and approximately $800,000 in prejudgment interest, as well as a civil penalty of approximately $4.03 million.

Investment advisers' undisclosed conflicts of interest have long been a focus of SEC enforcement actions and settlements. In particular, this settlement evokes echoes of the research analyst settlements of the early 2000s. The SEC asserted that Bank's commercial interests in Third Party gave rise to an undisclosed conflict of interest with respect to Adviser's clients because Bank executives may have sought to influence the operation of Adviser's due diligence in Third Party's favor. Advisers that are affiliated with large financial institutions should consider whether: (i) policies erecting a "wall" between advisory diligence and other lines of business should be revisited or strengthened; and (ii) potential conflicts arising from other lines of business should be disclosed, or both.

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

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