Investment Management Regulatory Update

July 31, 2019

Rules and Regulations

- SEC Staff Grants No-Action Relief Extending Existing Exemptive Relief under Section 15(a) of the Investment Company Act to Affiliated Sub-Advisers
- SEC Staff Grants No-Action Relief under Sections 13(a)(1) and 34(b) of the Investment Company Act
- SEC Adopts Amendments to the Auditor Independence Rules
- Davis Polk Publishes Visual Memorandum Related to Regulation Best Interest and Related Interpretations
- SEC Staff Grants No-Action Relief Allowing a Business Development Company to Treat a Proposed Merger as a Realization Event under Section 205(b)(3) of the Advisers Act

Industry Update

- Allison Herren Lee Sworn In as SEC Commissioner
- SEC Seeks Public Comment on Ways to Harmonize Private Security Offerings
- OCIE Issues Risk Alert Regarding Compliance Practices for Employees with a History of Disciplinary Events

Litigation

- SEC Settles with Large Financial Institution for Overcharging its Clients for Out-Of-Pocket Expenses
- SEC Charges Investment Adviser and Principal with Fraud for Misrepresentations to Clients and Misappropriation of Investor Funds; Issues Fines of $1.3 Million
- Manhattan Jury Finds Fund Founder, Trader Guilty of Fraud and Conspiracy to Inflate Fund Valuation

Rules and Regulations

SEC Staff Grants No-Action Relief Extending Existing Exemptive Relief under Section 15(a) of the Investment Company Act to Affiliated Sub-Advisers

On July 9, 2019, the Division of Investment Management of the Securities and Exchange Commission (the “**SEC**”) issued a no-action letter (the “**Letter**”) extending existing manager-of-managers exemptive relief from Section 15(a) of the Investment Company Act of 1940, as amended (the “**Investment Company Act**”), and related disclosure requirements to affiliated subadvisory agreements. Section 15(a) of the Investment Company Act states, in part, that it is unlawful for any person to act as an investment adviser to a registered investment company “except pursuant to a written contract, which contract, whether with such registered company or with an investment adviser of such registered company, has been approved by the vote of a majority of the outstanding voting securities of such registered company."

By way of background, the SEC has issued numerous manager-of-managers exemptive orders in the past that allowed: (i) funds or an adviser to enter into or materially amend subadvisory agreements with unaffiliated subadvisers without shareholder approval; and (ii) funds to disclose the fees paid to the unaffiliated subadvisers on an aggregate, rather than an individual, basis, subject to certain terms and conditions. Recently, the SEC issued an exemptive order (the "**New Order**") extending the traditional manager-of-managers relief to cover not just unaffiliated subadvisers, but also affiliated subadvisers subject to certain conditions.

In granting the no-action relief, the staff of the SEC indicated that it would not recommend enforcement action to the SEC under Section 15(a) against a person covered by an existing manager-of-managers exemptive order that only applies to unaffiliated subadvisers, if the fund or Adviser relies on its prior relief with respect to an affiliated subadviser, as long as the conditions contained in the New Order are followed, including, among others, a requirement that the board "evaluate any material conflicts that may be present in a subadvisory arrangement" when making a subadviser change or part of its annual review process, which requires the board to make a finding that the change or continuation is in the best interests of the fund and its shareholders and does not involve a conflict of interest "from which the [a]dviser, a [s]ubadviser, any officer or [t]rustee of the [s]ubadvised [f]und, or any officer or board member of the [a]dviser derives an inappropriate advantage." The conditions in the New Order contain additional requirements regarding the information provided to the board, including information regarding "any material interest in the proposed new [s]ubadviser…held directly or indirectly by the [a]dviser or a parent or sister company of the [a]dviser, and any material impact the proposed [s]ubadvisory [a]greement may have on that interest[,]" as well as "any arrangement or understanding in which the [a]dviser or any parent or sister company of the [a]dviser is a participant that (A) may have had a material effect on the proposed [s]ubadviser [c]hange…or (B) may be materially affected by the proposed [s]ubadviser [c]hange…."

According to the SEC staff, the relief granted by the Letter will provide additional flexibility to funds and Advisers operating under prior multi-manager relief applying only to unaffiliated subadvisers, without having to seek amendments to those orders.

- **See a copy of the Letter**
- **See a copy of the Incoming Letter**
- **See a copy of the New Notice**

SEC Staff Grants No-Action Relief under Sections 13(a)(1) and 34(b) of the Investment Company Act

On June 24, 2019, the Division of Investment Management of the SEC issued a no-action letter (the "**Letter**"), granting assurances that it would not recommend enforcement action against an index-based fund for violations of Sections 13(a)(1) and 34(b) of the Investment Company Act where the index-based fund exceeds the limits of a "diversified company" (as defined in Section 5(b)(1) of the Investment Company Act), provided that the index-based fund satisfies certain specified conditions.

Section 5(b) of the Investment Company Act divides management companies into "diversified companies" and "non-diversified companies" based on their relative asset mix. Section 5(b)(1) defines a "diversified company" as a management company where "at least 75 per centum of the value of its total assets is represented by cash and cash items (including receivables), Government securities, securities of other investment companies, and other securities for the purposes of this calculation limited in respect of any one issuer to an amount not greater in value than 5 per centum of the value of the total assets of such management company and to not more than 10 per centum of the outstanding voting securities of such issuer." Section 5(b)(2) defines a "non-diversified company" as any management company that is not a "diversified company." Additionally, Section 34(b) makes it unlawful for any person to "make any untrue statement of a material fact in any registration statement, application, report, account, record, or other document filed or transmitted pursuant to this title or the keeping of which is required…."

According to the incoming letter (the "**Incoming Letter**"), certain "index-based funds" (*i.e.*, open-end funds or exchange-traded funds) that seek to track the performance of broad-based indices may inadvertently cease to be diversified companies as a result of changes in the relative market capitalizations or index weightings of one or more constituents of their target indices. The Incoming Letter indicates that certain constituents of large cap U.S. equity growth broad-based indices have grown to represent more than 5% of their respective indices (each such index, an "**Affected Index**"). According to the Incoming Letter, and as a result of such growth, index-based funds that hold themselves out as diversified companies may inadvertently become non-diversified companies by virtue of their efforts to track an Affected Index; such a transition to non-diversified status would violate Section 13(a)(1) of the Investment Company Act, which requires a registered investment company to obtain authorization via the vote of a majority of its outstanding voting securities prior to changing its sub-classification from a diversified company to a non-diversified company.

According to the Incoming Letter, the relief requested: (i) is consistent with the expectations of investors in an index-based fund; (ii) would minimize portfolio disruption and unnecessary costs; and (iii) would permit Affected Index-based funds to continue investing in a manner consistent with their stated objectives, disclosures to their investors and regulatory constraints.

According to the Letter, the staff would not recommend enforcement against an index-based fund that exceeds the limits for a diversified company to the extent necessary to approximate the composition of the fund's target broad-based index, provided that it updates its registration statement to reflect its ability to exceed the diversification limits and the risks associated with exceeding such limits and provides notice to its shareholders of the fund's updated diversification policy.

- **See a copy of the Letter**
- **See a copy of the Incoming Letter**

SEC Adopts Amendments to the Auditor Independence Rules

On June 18, 2019, the SEC adopted amendments to Rule 2-01 of Regulation S-X (the "**Amendments**"), the SEC's auditor independence rules (the "**Rules**"), in order to "refocus the analysis that must be conducted to determine whether an auditor is independent when the auditor has a lending relationship with certain shareholders of an audit client" during an audit or professional engagement period by an auditor.

According to the adopting release announcing the Amendments (the "**Adopting Release**"), the Rules currently require auditors and accountants to be independent of audit clients "in both fact and in appearance." The Rule provides a non-exhaustive list of circumstances the SEC considers to be inconsistent with the independence requirements of the Rule, which includes direct financial relationships between auditors and their clients and circumstances in which auditors have a financial interest in their audit client. Specifically, Rule 2-01(c)(1)(ii)(A) of Regulation S-X (the "**Loan Provision**") currently provides that an accountant is not independent when: (a) the accounting firm; (b) any covered person of the accounting firm; or (c) any such covered person's immediate family members have any loan to or from: (i) an audit client; (ii) an audit client's officers or directors; or (iii) record or beneficial owners of more than 10 percent of the audit client's equity securities.

As noted in the Adopting Release, the Amendments modify the Loan Provision's auditor independence analysis by: (a) limiting the analysis under the Loan Provision only to beneficial ownership without also analyzing record ownership; (b) introducing a "significant influence" test to replace the bright-line 10% ownership test to determine whether a beneficial ownership relationship may affect independence; (c) adding a “known through reasonable inquiry” standard to the identification of beneficial owners of the audit client’s equity securities; and (d) amending the Loan Provision’s definition of “audit client” for a fund under audit to exclude funds that would otherwise be considered affiliates of the audit client.

The Loan Provision of the Rule now states that “[a]n accountant is not independent when the accounting firm, any covered person in the firm, or any of his or her immediate family members has” any “loan (including any margin loan) to or from an audit client, or an audit client’s officers, directors, or beneficial owners (known through reasonable inquiry) of the audit client’s equity securities where such beneficial owner has significant influence over the audit client, except for [certain specified loans, including, among others automobile leases and loans securitized by the automobile] obtained from a financial institution under its normal lending procedures, terms, and requirements.”

According to the Adopting Release, the SEC became aware that the existing Loan Provision “may not have been functioning as it was intended[,]” through public disclosures and consultations with certain parties, including registered investment companies, other pooled investment vehicles and registered investment advisers, in which such parties expressed concerns. The Adopting Release notes that through such disclosures and consultations, it became apparent that certain fact patterns exist in which an auditor’s objectivity and impartiality “are not impaired despite a failure to comply” with the current Loan Provision. According to the Adopting Release, the Amendments will better identity relationships that could impair an auditor’s objectivity and impartiality and de-emphasize situations that are less likely to pose such threats and will therefore focus the Loan Provision’s analysis on borrowing relationships that are “more important to investors.”

- **See a copy of the Adopting Release**

Davis Polk Publishes Visual Memorandum related to Regulation Best Interest and Related Interpretations

Davis Polk has published a visual memo regarding Regulation Best Interest (“**Reg BI**”), a new standard of conduct regulations for SEC-registered broker-dealers and their associated persons that are natural persons. Adopted in June 2019, Reg BI has a compliance date set for June 30, 2020. The visual memo describes the updated obligations of registered broker-dealers under Reg BI. The memorandum also addresses the recently adopted relationship summary disclosure requirement on Form CRS as well as two newly adopted interpretive releases relating to the Investment Advisers Act of 1940 (the “**Advisers Act**”): one on the investment adviser fiduciary duty and the other on the solely incidental exemption for broker-dealers from investment adviser regulation.

- **See a copy of the Visual Memorandum**

SEC Staff Grants No-Action Relief Allowing a Business Development Company to Treat a Proposed Merger as a Realization Event under Section 205(b)(3) of the Advisers Act

On June 24, 2019, the Division of Investment Management of the SEC issued a no-action letter (the “**Letter**”) stating that they would not recommend enforcement action under Section 205(b)(3) of the Advisers Act against a business development company (“**BDC**”) or its investment adviser seeking to treat a proposed merger as a realization event for the purpose of paying certain capital gains-based performance fees to the BDC’s investment adviser.

According to the incoming letter (the “**Incoming Letter**”), two BDCs were both externally managed, closed-end, non-diversified management investment companies that had elected to be regulated as BDCs under the Investment Company Act. The Incoming Letter states that while one BDC is listed, publicly traded and raised its equity capital through an initial public offering, the other BDC is not listed or publicly traded and raised its equity capital through private placements to accredited investors. Additionally, the Incoming Letter notes that, as of March 31, 2019, “97.6% of [the non-traded BDC’s] investments at fair value overlapped with those of [the listed BDC], and 98.3% of [the listed BDC's] investments at fair value were also in [the non-traded BDC's] portfolio[,]" and that both BDCs value their portfolio investments using the same valuation procedures.

According to the Incoming Letter, the BDCs announced that they had entered into an agreement and plan of merger, "providing for the merger…of [the non-traded BDC] into [the listed BDC], whereby the stockholders of [the non-traded BDC] would receive shares of [the listed BDC] common stock…that trade on The Nasdaq Global Select Market…." The Incoming Letter stated that the adviser and BDCs view the merger as a liquidation event that would entitle the adviser to a performance fee from [the non-traded BDC].

Section 205(a)(1) of the Advisers Act prohibits an investment adviser from entering into any advisory contract that provides for compensation to the adviser on the basis of a share of capital gains upon or capital appreciation of a client's funds. Section 205(b)(3) provides an exception from this general prohibition for advisory contracts with BDCs where the performance fee is based on "realized capital gains upon the funds of the [BDC] over a specified period." The Incoming Letter classifies the proposed merger of the BDCs as a "realization event," enabling a performance fee to be paid to the adviser based on capital appreciation, and requested the staff's assurances that they will not recommend enforcement based on such classification, to which the staff of the SEC agreed.

According to the SEC staff, because of the "very fact-specific nature of this request…the position expressed in this letter applies only to the entities seeking relief, and no other entity may rely on this position."

- **See a copy of the Letter**
- **See a copy of the Incoming Letter**

Industry Update

Allison Herren Lee Sworn In as SEC Commissioner

On July 8, 2019, Allison Herren Lee was sworn into office as a commissioner of the SEC. Commissioner Lee was nominated to the SEC by President Trump and unanimously confirmed by the U.S. Senate. Commissioner Lee fills a term that expires on June 5, 2022.

- **See a copy of the Press Release**

SEC Seeks Public Comment on Ways to Harmonize Private Security Offerings

On June 19, 2019, the SEC issued a concept release (the "**Concept Release**") to solicit comments on several exemptions from registration under the Securities Act of 1933 (the "**Securities Act**"). According to an SEC press release, this Concept Release is part of an ongoing effort to "simplify, harmonize, and improve the exempt offering framework to expand investment opportunities while maintaining appropriate investor protections and to promote capital formation." According to SEC Chairman Jay Clayton, "We are taking a critical look at our exemptions from registration to ensure that our multifaceted private offering framework works for investors and entrepreneurs alike…."

While most of the Concept Release focuses on the different private offering exemptions, there are sections that focus on opening up investments in private companies and private funds to retail investors, which is of importance to investment managers. One of the major themes of the Concept Release is that the SEC has recognized that retail investors' inability to participate in private opportunities, either directly or through investment funds, may be disadvantaging them economically. For example, according to the Concept Release, only approximately 13% of U.S. households currently qualify as "accredited investors" under the current criteria. Similarly, the Concept Release also noted that accredited investors are not evenly dispersed across the country, thus potentially limiting private investment opportunities and capital formation in underrepresented regions. As such, while we do not expect any immediate changes in the securities laws, the Concept Release indicated that the SEC is interested in exploring ways to help retail investors access these investment opportunities. In particular, as discussed in more detail below, the Concept Release explored various ways in which to expand retail investor participation in these opportunities, including: (i) changing the private offering requirements to allow more retail participation; and (ii) enabling registered funds to invest more heavily in private investment opportunities and private funds.

In terms of allowing more retail participation in private offerings, the SEC raised the possibility of revisions to Regulation D. According to the Concept Release, these revisions could include: (i) changes to the definition of a “general solicitation,” which might allow for broader advertisements of exempt securities offerings; (ii) permitting non-accredited investors to purchase securities in a Regulation D offering that involves general solicitation; and (iii) reducing the information requirements for Regulation D offerings made to non-accredited investors.

In addition to these potential changes, the SEC also discussed changes to the definition of “accredited investor” set forth in Regulation D. According to the SEC, the term “accredited investor” is “intended to encompass those persons whose financial sophistication and ability to sustain the risk of loss of investment or ability to fend for themselves render the protections of the Securities Act’s registration process unnecessary.” Citing data that demonstrates the manner in which the current “accredited investor” definition limits the pool of investors eligible to participate in private offerings (by setting minimum income or net worth thresholds for natural persons), the SEC inquired whether it should change the definition of accredited investor. In the Concept Release, the SEC posited several possible options for expanding the definition of an accredited investor, including: (i) creating alternative criteria (such as education or financial sophistication) for meeting the definition; (ii) allowing investors to self-certify that they are accredited investors; or (iii) allowing otherwise non-accredited investors to retain professionals to advise them in order to qualify as accredited investors without limitation.

In terms of retail investor access to private investment opportunities (or private funds) through registered funds, the SEC solicited comments on whether the current regulations impede the participation of registered investment funds in exempt offerings, and whether any such regulations should be changed to ease the process of participation (*e.g.*, “Are there any regulatory provisions or practices including those promulgated or engaged in by the [SEC], that discourage or have the effect of discouraging participation by registered investment companies and BDCs in exempt offerings?”). For example, the SEC cited current liquidity restrictions and valuation requirements—which prevent open-end registered investment funds from holding significant amounts of securities issued in exempt offerings—as a limitation on the use of registered investment funds by retail investors for accessing the private markets.

The SEC also focused its discussion in this area heavily on interval funds (registered closed-end funds that make periodic repurchase offers pursuant to Rule 23c-3 under the Investment Company Act) and tender offer funds (registered closed-end funds that make periodic repurchase offers pursuant to issuer tender offers) as possible, but underutilized, avenues for retail investors to gain exposure to smaller public and private companies whose shares have limited or no liquidity, and asked, “Should we consider making any changes to our rules regarding interval funds [and tender offer funds]? If so, what types of changes?” as well as “To what extent would any changes to the interval fund rule lessen the need for tender offer funds?”

The SEC also inquired about the ability of closed-end funds (including BDCs) to invest in private funds, and raised the following questions: “What restrictions should there be, if any, on the ability of closed-end funds, including BDCs, to invest in private funds, including private equity funds and hedge funds, and to offer their shares to retail investors? For example, should there be a maximum percentage of assets that closed-end funds and BDCs can invest in private funds? Should such closed-end funds be required to diversify their investments across a minimum number of private funds, if they are not restricting their offerings to accredited investors?"

The questions raised by the SEC in the Concept Release regarding retail investor participation in private investment opportunities and private funds have profound implications for investment managers of all types, presenting both opportunities and risks. In terms of opportunities, the SEC has clearly signaled a willing to at least consider changes to its rules to provide more access to these investments to retail investors. Fund managers seeking to design new products that could fill this gap – such as structures that would be attractive and appropriate for 401(k) plan investors – may have an opportunity to work with the SEC to try to bring these new types of products to market, although the SEC has clearly not committed itself to making any changes. Conversely, on the risk side, the introduction of new products that provide the same type of investment exposures as traditional private equity funds, but with different fee and liquidity structures, could up-end existing business models.

The Concept Release makes clear that the SEC is conducting "a comprehensive review of the design and scope of [the] framework for offerings that are exempt from registration[,]" but the SEC also made clear that it has not committed to a specific course of action on any of these topics. The SEC indicated that it would like to receive more information and input from industry participants before pursuing a particular strategy and has requested comments by September 24, 2019.

- **See a copy of the Concept Release**

OCIE Issues Risk Alert Regarding Compliance Practices for Employees with a History of Disciplinary Events

On July 23, 2019, the Office of Compliance Inspections and Examinations ("**OCIE**") of the SEC issued a risk alert (the "**Risk Alert**") relating to an examination initiative that assessed the oversight practices of registered investment advisers ("**Advisers**") that previously employed or currently employ an individual with a history of disciplinary events (the "**Initiative**"). According to the Risk Alert, OCIE staff conducted over 50 examinations in 2017 and the examined Advisers collectively managed approximately $50 billion in assets for nearly 220,000 clients. The Risk Alert notes that the examinations did not "solely focus on the supervisory practices as they relate to the individuals with prior disciplinary histories. Rather, due to the importance that supervisory practices have in setting a strong 'tone at the top' and compliance culture, the staff reviewed the advisers' supervisory practices firm-wide."

The Risk Alert stated that the scope of the Initiative focused on Advisers' practices in the following areas:

- Compliance programs and supervisory oversight practices: OCIE staff reviewed whether Advisers' compliance policies and procedures "were reasonably designed to detect and prevent violations of the Advisers Act by the firm and its supervised persons, particularly those policies and procedures covering the activities of certain previously-disciplined individuals."
- Disclosures: OCIE staff reviewed whether disclosures - particularly disclosures related to "previously-disciplined individuals and their prior disciplinary events" - in public statements, marketing materials and filings were "full and fair, included all material facts, and were not misleading."
- Conflicts of interest: OCIE staff reviewed whether the Adviser "identified, addressed, and fully and fairly disclosed all material conflicts of interest that could affect the advisory relationship," particularly with respect to conflicts in connection with compensation arrangements and account management.

In the Risk Alert, OCIE staff identified common deficiencies observed during the course of the Initiative, including:

- Observations Specific to Disciplinary Histories:
  - Full and Fair Disclosure: Nearly half of the examined Advisers' disclosure deficiencies resulted from firms providing inadequate information regarding prior disciplinary events, including:
    - Advisers that omitted material disclosures "regarding disciplinary histories of certain supervised persons or the [A]dviser itself[,]" often because Advisers "solely relied on these supervised persons to self-report" information about their required disclosures.
    - Advisers that included "incomplete, confusing, or misleading information regarding disciplinary events." For example, not including the total number of events, the date of the event, the allegations or whether the supervised persons were found to be at fault.
    - Advisers that did not "timely update and deliver disclosure documents to clients," such as updating Form ADV "for new disciplinary events of supervised persons…."
  - Effective Compliance Programs: Many Advisers did not adopt and implement compliance policies and procedures addressing "the risks associated with hiring and employing individuals with disciplinary histories." OCIE staff observed that some Advisers did not have processes reasonably designed to identify whether: (i) supervised persons' self-attestations regarding disciplinary events accurately described those events; or (ii) supervised persons' self-attestations that they were not the subject of reportable events or recent bankruptcies were accurate.
- Additional Staff Observations: Compliance and Supervision
  - Supervision: Many Advisers did not adequately supervise or maintain appropriate standards of conduct for supervised persons, such that Advisers' policies and procedures did not sufficiently document the responsibilities of or expectations for supervised persons. For example, Advisers did not:
    - "Oversee whether fees charged by supervised persons were disclosed or assess whether the services clients paid for were performed."
    - Adopt and implement advertising policies and procedures providing sufficiently specific guidance to supervised persons who prepared their own advertising materials.
    - Have a policy regarding reviewing the activities of supervised persons, including supervised persons with disciplinary histories, working from remote locations.
  - Oversight: Many Advisers "did not confirm that supervised persons identified as responsible for performing certain compliance policies and procedures" were actually performing these duties, including key regulatory and business responsibilities such as monitoring the appropriateness of client account types and maintaining accurate books and records.
  - Compliance Policies and Procedures: "[S]everal [A]dvisers had adopted policies and procedures that were inconsistent with their actual business practices and disclosures[,]" including those addressing commissions, fees and expenses.
  - Annual Compliance Reviews: Some Advisers' annual reviews were insufficient because they did not adequately document the review and appropriately determine risk areas applicable to the firms, "or identify certain risks at all."
- Additional Staff Observations: Disclosure of Conflicts of Interest:

- Compensation Arrangements: Several Advisers had “undisclosed compensation arrangements, which resulted in conflicts of interests that could have impacted the impartiality of the advice the supervised persons gave to their clients.” For example, some Advisers did not disclose that:
    - “Forgivable loans were made to the [A]dvisers or supervised persons, the terms of which were contingent upon client-based incentives that may have unduly influenced the investment decision-making process, resulted in higher fees and expenses for the affected clients, or both.”
    - “Supervised persons were required to incur all transaction-based charges associated with executing client transactions, which created incentives for the supervised persons to trade less frequently on behalf of their clients.”

In the Risk Alert, OCIE staff also identified best practices implemented at some of the Advisers that may “help other firms address the weaknesses discussed above[,]” including:

- Adoption of “written policies and procedures that specifically address what must occur prior to hiring supervised persons that have reported to the [A]dviser disciplinary events.” Advisers’ written policies and procedures required investigations of the disciplinary events and determining whether barred individuals were eligible to reapply for their licenses.
- Enhancement of due diligence practices for hiring supervised persons to identify disciplinary events. Advisers employed a variety of diligence measures, including conducting background checks, conducting internet and social media searches, fingerprinting candidates, using third parties to research candidates, contacting personal references and verifying educational claims. Some Advisers also: (i) requested that candidates provide copies of their Form U5s, if applicable; (ii) reviewed new hires’ Form U5 filings 30 or more days after they are hired (“this type of procedure may identify termination notices the new hire did not disclose that were filed after the hiring decision was made”); and (iii) “checked CRD/IARD for supervised persons’ filings and re-checked the filing information after a designated period of time[.]”
- Establishment of “heightened supervision practices when overseeing supervised persons with certain disciplinary histories.” OCIE staff observed that Advisers with written policies and procedures specifically addressing oversight of supervised persons with disciplinary histories were more likely to identify misconduct than Advisers without such protocols.
- Adoption of written policies and procedures “addressing client complaints related to supervised persons.” Advisers with such written policies and procedures were “more likely to have reported the receipt of at least one complaint related to their supervised persons” and were more likely to “escalate matters of concern raised in these complaints than [A]dvisers without written protocols.”
- Inclusion of “oversight of persons working out of remote offices in compliance and supervisory programs, particularly where supervised persons with disciplinary histories are located in remote offices.”

OCIE staff noted that as a result of the Initiative, some Advisers “elected to amend disclosures, revise compliance policies and procedures, or change other practices.” OCIE staff also encouraged advisers to consider “the risks presented by, as well as the disclosure requirements triggered by” hiring and employing supervised persons with disciplinary histories and to implement compliance programs, policies and procedures that specifically address those risks and disclosure requirements.

- **See a copy of the Risk Alert**

Litigation

SEC Settles with Large Financial Institution for Overcharging its Clients for Out-Of-Pocket Expenses

On June 27, 2019, the SEC issued an order (the "**Order**") instituting and settling cease-and-desist proceedings against a financial institution (the "**Custody Bank**") for allegedly overcharging its clients—mutual fund and other registered investment companies (together, "**RICs**") for which it served as a custody bank—by over $170 million between 1998 and 2015.

According to the Order, the Custody Bank's fee agreements with its RIC clients typically provided that the Custody Bank would be paid a fee based on a percentage of the client's assets, and that the RIC client would reimburse the Custody Bank for out-of-pocket expenses "generally understood in the securities industry to mean costs for items paid by the custodian on behalf of the investor" that are "reimbursable to the custodian." The SEC alleged that the Custody Bank overcharged its RIC clients for these "out-of-pocket" expenses by imposing charges that exceeded its actual costs.

Of the over $170 million in alleged overcharges, approximately $110 million represented the Custody Bank's alleged overcharges of costs for "SWIFT messages." The Custody Bank presented SWIFT messages as an "out-of-pocket" expense, but allegedly charged its clients far more than the actual cost for these messages. According to the SEC, Custody Bank personnel noted as early as 2005 that clients were "not charged at the true costs." While certain clients would receive cost reductions in response to specific requests or during contract renegotiations, the Custody Bank allegedly did not reduce rates for SWIFT messages to its actual out-of-pocket costs for all clients during the relevant time period.

In addition, the SEC alleged that the Custody Bank also charged its RIC clients more than its costs for other "out-of-pocket" expenses as well, including: (i) asset pricing and valuation services from third-party vendors; (ii) statements on auditing standards; (iii) service and organization control reports; and (iv) preparing SEC Rule 17f-5 reports. Other, less significant categories of expenses for which the Custody Bank charged more than its costs also included expenses related to: issuing checks, delivery services, printing and copying, archiving client records, telephone services, computer equipment and wire transfers. For a majority of these expenses, the Custody Bank had previously set a rate at which to charge clients, but ultimately failed to both update that rate over time and to implement internal procedures to periodically reassess the unit costs of those expenses.

The SEC Order noted that the Custody Bank "self-reported its conduct to the [SEC]," provided the staff with "substantial cooperation" and committed to several remedial measures. Among other measures, the Custody Bank committed to reimburse clients for the amounts, with interest, that it determined it charged in excess of its costs, and retained a consulting firm to assist it in determining the amount of overcharges. The Custody Bank also enhanced its compliance programs and control systems relating to invoicing RIC clients.

As a result of the conduct described above, the SEC found that the Custody Bank willfully violated Section 34(b) of the Investment Company Act ("which prohibits any person from making any untrue statement of material fact in any registration statement, application, report, account, record, or other document filed or transmitted pursuant to the Investment Company Act or the keeping of which is required pursuant to…the Investment Company Act and provides that it shall be unlawful for any person so filing, transmitting, or keeping any such document to omit to state therein any fact necessary in order to make the statements therein, in light of the circumstances under which they were made, from being materially misleading"), and caused violations of Section 31(a) of the Investment Company Act and Rule 31a-1(a) ("which require RICs to maintain and keep current the accounts, books, and other documents relating to its business which constitute the record forming the basis for its required financial statements") and Rule 31a-1(b) thereunder ("which require RICs to maintain records of all receipts and disbursements of cash and all other debits and credits"). The Custody Bank agreed to pay $48,473,242 in disgorgement, including prejudgment interest of $307,619, which would be distributed to its clients to reimburse them for overcharges after October 2011. The Custody Bank also agreed to a civil monetary penalty of $88,780,861, consented to the entry of the Order and agreed to cease and desist from future violations.

- **See a copy of the Order**

SEC Charges Investment Adviser and Principal with Fraud for Misrepresentations to Clients and Misappropriation of Investor Funds; Issues Fines of $1.3 Million

On July 1, 2019, the SEC announced the settlement of charges against a formerly-registered investment adviser (the "**Adviser**") and its principal (the "**Principal**") for allegedly defrauding retail investment advisory clients by failing to disclose material conflicts of interest. Principal was also charged for fraudulent misuse of approximately $500,000 of one investor's funds to pay personal expenses.

The SEC alleged that from 2014 to early 2016, approximately 40 retail clients of Principal and Adviser invested more than $7 million in securities issued by an affiliate of a private company (the "**Company**"). The investment group managing the Company securities had been the subject of a **previous** SEC enforcement action for defrauding more than 1,500 investors nationwide. According to the SEC's order, Principal and Adviser failed to disclose to their clients that Company had provided Adviser with a $1.5 million loan and access to a $2 million line of credit under terms that created an incentive to recommend Company investments. In both client communications and required filings to the SEC, Adviser and Principal did not disclose the $1.5 million loan or the $2 million line of credit Company provided, or their conflicts of interest in recommending that clients invest in Company securities.

The SEC also alleged that in early 2017, Principal advised an Adviser client to purchase an interest in Adviser for $1 million. According to the SEC, Principal misrepresented that the client's investment would be used to support and expand Adviser's business and discouraged the client from seeking an independent valuation of Adviser before investing $1 million in the firm. The SEC alleges that these statements were materially misleading because Principal knew and failed to disclose that he planned to use the client's money for his personal expenses. Principal began using the client's funds for such purposes on the same day that Adviser received them, and had used approximately half the client's money to pay his personal taxes, other personal debt and cash withdrawals for himself within ten days of receiving the money.

The SEC found that Principal and Adviser violated Sections 206(1) and 206(2) of the Advisers Act, which prohibit fraudulent conduct by an investment adviser, Section 17(a)(2) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10(b-5) thereunder, which prohibit fraudulent conduct in the offer or sale of securities and in connection with the purchase or sale of securities, and 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."

Adviser and Principal consented to the issuance of the SEC order, which found that they violated the antifraud provisions of the federal securities laws, censured Adviser, ordered them to cease and desist from future violations and ordered them to pay, jointly and severally, disgorgement and prejudgment interest of $1,047,971 and a penalty of $275,000, all of which will be distributed to harmed investors. Principal will also be permanently barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization.

- **See a copy of the Order**

Manhattan Jury Finds Fund Founder, Trader Guilty of Fraud and Conspiracy to Inflate Fund Valuation

On July 11, 2019, following a six-week trial, a jury in the United States District Court for the Southern District of New York found securities traders guilty of charges that they executed a scheme to inflate the assets of funds managed by an investment adviser (the "**Adviser**").

On May 7, 2018, three Adviser employees, were indicted on four counts of securities fraud, wire fraud, conspiracy to commit securities fraud and conspiracy to commit wire fraud. According to the indictment, the Adviser, like many fund managers, earned fees based on the amount of assets under management and the performance of the fund. The indictment alleged that two of the traders engaged in a scheme to mismark the value of the securities held in the funds that the Adviser managed, which fraudulently inflated the NAV of the funds. The two traders were alleged to have engaged in the mismarking in two ways: first, by securing inflated quotes for particular securities from brokers in exchange for directing business to those brokers; and second, by calculating an "imputed mid" price for securities by adding a "sector spread" to broker bids. The indictment alleged that the mismarking scheme "evolved as a result of demands by [the two traders] that [the Adviser] maintain its track record of success . . . regardless of . . . the actual performance of the funds." The SEC filed a civil complaint against the Adviser and the three traders on May 9, 2018, arising out of the same alleged misconduct, as detailed in our May 31, 2018 **Investment Management Regulatory Update**.

The jury trial of two of the traders, before U.S. District Judge Katherine Polk Failla, began on June 5, 2019. The third trader, who had pleaded guilty, testified against the other two traders. Other prosecution witnesses included a broker who testified that he had provided inflated quotes to the traders so that they would continue to direct business to him. After deliberating for nearly two days, the jury found the two traders guilty on all four counts of securities fraud, wire fraud, conspiracy to commit securities fraud and conspiracy to commit wire fraud. No sentencing date has been set; counsel for the two traders have stated that they intend to appeal.

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

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

Nora M. Jordan	212 450 4684	**nora.jordan@davispolk.com**
James H.R. Windels	212 450 4978	**james.windels@davispolk.com**
John G. Crowley	212 450 4550	**john.crowley@davispolk.com**
Amelia T.R. Starr	212 450 4516	**amelia.starr@davispolk.com**
Leor Landa	212 450 6160	**leor.landa@davispolk.com**
Gregory S. Rowland	212 450 4930	**gregory.rowland@davispolk.com**
Michael S. Hong	212 450 4048	**michael.hong@davispolk.com**
Lee Hochbaum	212 450 4736	**lee.hochbaum@davispolk.com**
Marc J. Tobak	212 450 3073	**marc.tobak@davispolk.com**
Matthew R. Silver	212 450 3047	**matthew.silver@davispolk.com**