Investment Management Regulatory Update

December 26, 2019

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Rules and Regulations

SEC Proposes Amendments to Modernize the Advertising and Cash Solicitation Rules

On November 4, 2019, the Securities and Exchange Commission (the "**SEC**") proposed amendments to Rule 206(4)-1 (the "**advertising rule**") and Rule 206(4)-3 (the "**solicitation rule**") under the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"). The proposed amendments would modernize the two rules, which have remained largely unchanged since their adoptions decades ago.

Davis Polk has published a **client alert** and a **client memorandum** discussing the proposed amendments to the advertising rule and the solicitation rule.

SEC Proposes to Modernize Regulation of Derivatives Use by Registered Funds

On November 25, 2019, the SEC proposed a substantially revised version of proposed new Rule 18f-4 under the Investment Company Act of 1940, as amended (the "**Investment Company Act**"), which was originally proposed on December 11, 2015. According to the proposing release, proposed Rule 18f-4 would apply to registered investment companies (other than money market funds and UITs) and business development companies, and is designed to promote the ability of registered funds to use derivatives in a broad variety of ways that serve investors, while still addressing the investor protection concerns underlying Section 18 of the Investment Company Act.

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Davis Polk has published a **client alert** discussing the proposed rule and will publish a full client memorandum shortly.

SEC Issues FAQs for Form CRS

On November 26, 2019, the SEC Division of Investment Management and the Division of Trading and Markets issued answers to frequently asked questions (the "**FAQs**") about relationship summaries on Form CRS ("**Relationship Summaries**"). The FAQs provide guidance on the formatting and delivery requirements for such Relationship Summaries, including:

Relationship Summary Format

According to the FAQs, a broker-dealer or investment adviser offering multiple types of services should prepare only one Relationship Summary describing all of its principal relationships and services. For example, the FAQs state that a broker-dealer that offers several brokerage services, such as self-directed, full-service, and employer-sponsored retirement plan options, must describe all such services in a single Relationship Summary. Similarly, the FAQs state that an investment adviser that offers multiple services, such as a wrap fee program, advice to 401(k) plan participants, and discretionary asset management for high net worth clients, should prepare only one Relationship Summary addressing these services.

The FAQs state that broker-dealers and investment advisers should consult with the software provider of the application they use to create their PDF Relationship Summaries to determine how to create machine-readable headings that comply with General Instruction 7.A.(i) to Form CRS. The FAQs highlight specific instructions for users of Microsoft Word and Adobe.

Relationship Summary Delivery Requirements

According to the FAQs, a firm must deliver its Relationship Summary to each existing retail investor client and customer within 30 days after the date the firm is required to electronically file its Relationship Summary with the SEC. The FAQs state that a firm may satisfy this requirement either by delivering the Relationship Summary separately or as part of the delivery of information that the firm already provides. For example, the FAQs state that a firm can include its Relationship Summary in the mailing of its annual Form ADV update, account statements or other periodic reports. The FAQs also provide the following guidance for methods of delivery:

- A firm delivering its Relationship Summary in paper format as part of a package of documents must ensure the Relationship Summary is the first document.
- A firm delivering its Relationship Summary electronically must present the Relationship Summary prominently, e.g., with a direct link or in the body of the message, so that it is directly accessible to retail investors.

The FAQs state that an investment advisory firm is not required to deliver a Relationship Summary to pooled investment vehicles, such as hedge funds, private equity funds and venture capital funds, even if investors in those funds include natural persons who may be "retail investors" for purposes of Form CRS. According to the FAQs, investment advisers must deliver a Relationship Summary to each retail investor before or at the time of entering into an investment advisory contract. For purposes of Form CRS, "retail investor" is defined as "a natural person, or the legal representative of such natural person, who seeks to receive or receives services primarily for personal, family or household purposes." The FAQs state that pooled investment vehicles, such as hedge funds, private equity funds or venture capital funds, would not fall within this definition.

- **See a copy of the FAQs**

CFTC Adopts Amendments to Commodity Pool Operator and Commodity Trading Advisor Rules Regarding Exemptions for Family Offices, Harmonization with Certain JOBS Act Related Amendments and Non-U.S. Investors in De Minimis Exempt Pools

On November 25, 2019 the U.S. Commodity Futures Trading Commission (the "**CFTC**") issued a release (the "**Release**") adopting amendments to Part 4 of the CFTC's regulations, which governs the operations and activities of commodity pool operators ("**CPOs**") and commodity trading advisors ("**CTAs**"), including registration exemptions and exclusions for CPOs and CTAs and compliance obligations for CPOs and CTAs that are required to be registered. According to the Release, the CFTC first proposed amendments in October 2018 (the "**Proposed Amendments**") in order "to simplify the regulatory landscape for CPOs and CTAs without reducing the protections or benefits provided by those regulations, to increase public awareness about available relief by incorporating commonly relied upon no-action or exemptive relief in [CFTC] regulations, and to generally reduce the regulatory burden without sacrificing the [CFTC's] customer protection and other regulatory interests." After reviewing public comments on the Proposed Amendments, the CFTC has adopted the majority of the amendments as initially proposed, with certain procedural modifications (the "**Final Rules**"). The Final Rules "provide an exemption from registration for CPOs and CTAs of family offices; adopt exemptive relief consistent with the Jumpstart Our Business Startups Act of 2012 [the "**JOBS Act**"] by permitting general solicitation under applicable [CFTC] regulations; and clarify that non-U.S. persons, regardless of financial sophistication, are permitted participants in pools exempt under the applicable [CFTC] regulation."

The Release noted that the Proposed Amendments would have included an exemption from registration for qualifying CPOs operating commodity pools outside the United States. However, according to the Release, in response to comments expressing concern that these amendments "could have a significant impact on the compliance burdens of CPOs operating outside" the United States, the CFTC has withdrawn these amendments at this time and intends to reconsider them in a future rulemaking.

Family Offices

According to the Release, the Final Rules amend Regulations 4.13 and 4.14 to establish CPO and CTA registration exemptions for entities that meet the definition of "family office" (the "**Family Offices**") under Rule 202(a)(11)(G)-1 under the Advisers Act, which is consistent with past CFTC no-action relief. The Final Rules incorporate by reference the definitions of "family office" and "family client" from Rule 202(a)(11)(G)-1 under the Advisers Act into each of the exemptions. The Release noted that the CFTC believes that "familial relationships inherent in Family Offices provide a reasonable mechanism for protecting the interests of family clients and resolving disputes amongst them, and that the regulatory interest is lower than in typical, arms-length transactions where the CPO and the pool participants, or the CTA and its advisory clients, do not have close relationships and/or long-standing family history between them" and that "these unique characteristics reduce the need for and utility of the benefits and protections generally afforded by the [CFTC] regulatory regime for CPOs and CTAs and further justify providing Family Offices relief from that regime."

CPO Exemption

According to the Release, Regulation 4.13(a)(6) provides an exemption from CPO registration for a person with respect to a qualifying commodity pool, if (a) interests in the pool are exempt from registration under the Securities Act of 1933 (the "**Securities Act**"), and such interests are offered and sold only to "family clients"; (b) the person qualifies as a Family Office; and (c) the person reasonably believes, at the time of investment, or at the time of conversion for an existing pool, that each person who participates in the pool is a "family client" of the Family Office." The Release noted that in response to comments on the Proposed Amendments, the Final Rules clarify that the person claiming the exemption, rather than the commodity pool subject to the exemption, must meet the SEC's "family office" definition. According to the Release, the Proposed Amendments also would have required Family Offices claiming the CPO exemption to submit an initial notice filing, to be affirmed on an annual basis, in order to "ensure at least

an annual assessment of whether the CPO of the Family Office remains eligible to rely upon the [exemption]"; however, in response to concerns raised by commenters, the Final Rules eliminate the notice filing requirement. The Release stated that Family Offices "do not pose the same regulatory concerns as those of other CPOs that routinely engage in wider solicitation…and from whom the [CFTC] would generally require either a registration application or a notice filing for such exemption." According to the Release, the CPO registration relief provided by this exemption will be available on a self-executing basis. The Release noted that exempt Family Offices will remain subject to the recordkeeping requirements and special call authority applicable to all other exempt CPOs.

CTA Exemption

In addition, Regulation 4.14(a)(11) provides an exemption from CTA registration to a person who directs commodity trading advice solely to, and for the sole use of, "family clients." According to the Release, this exemption covers CTA activities on behalf of both individual family clients and pools composed of family client assets, as opposed to the originally proposed bifurcated approach under which CTA activities for commodity pools of Family Offices would have fallen under a separate exemption provided in Regulation 4.14(a)(5). The Release noted that the more comprehensive approach adopted by the Final Rules "greatly simplifies the compliance analysis for Family Offices and provides them a single CTA registration exemption to cover their advisory activities on behalf of all persons and entities meeting the SEC's 'family client' definition." The Release stated that, like most other exemptions under Regulation 4.14, this CTA exemption will operate on a self-executing basis and without a notice requirement.

According to the Release, the Final Rules do not supersede any prior CFTC staff letters providing that an entity is not a pool, "provided that a Family Office has determined its own situation to be substantively identical to the outlined facts and circumstances precipitating the letter relief." However, the Release noted that the adoption of the CPO and CTA exemptions for Family Offices, which will be effective 30 days after publication of the Release, will supersede two prior CFTC staff letters that provided no-action relief from registration for such entities.[1] The Release noted that Family Offices that qualify for the exemptions should "create and maintain an internal record documenting the relevant exemption they wish to claim, as well as their qualifications for that exemption."

JOBS Act Amendments

In addition, the Final Rules also amend certain exemptions in Part 4 of the CFTC's regulations to harmonize such exemptions with amendments to rules under the Securities Act made by the SEC pursuant to the JOBS Act, e.g., Rule 506(c) of Regulation D, which permits general solicitation under certain conditions. The Release stated that the CFTC believes "that harmonizing the impact of the JOBS Act on dually-regulated entities eliminates incompatibilities between comparable SEC and CFTC regulatory regimes, and generally provides legal certainty regarding these transactions in a manner that allows these entities to benefit from the new offering process under the JOBS Act…The amendments achieve the goal of permitting commodity pools operated by CPOs claiming relief under Regulations 4.7(b) or 4.13(a)(3) to avail themselves of the JOBS Act relief adopted by Congress, while still retaining the other requirements currently set forth in those regulations."

According to the Release, after the SEC's amendments to Regulation D and Rule 144A pursuant to the JOBS Act, persons marketing, selling or reselling securities pursuant to Rule 506(c) of Regulation D or Rule 144A could not necessarily qualify for a CPO registration exemption under CFTC Regulation 4.13(a)(3) or for exemptive relief from certain CPO compliance obligations under CFTC Regulation 4.7, each of which was subject to offering and marketing restrictions. The Release noted that in response to

[1] CFTC Letter No. 12-37 (Nov. 29, 2012); CFTC Letter No. 14-143 (Nov. 5, 2014).

concerns by market participants, the CFTC issued a relief letter[2] in 2014 "which provided relief so that CPOs of commodity pools, the securities of which are either offered and sold pursuant to [Rule 506(c)] of Regulation D, or resold to [qualified institutional buyers] under Rule 144A, were able to operate them pursuant to Regulations 4.7 and 4.13, even if they or their resellers engage in general solicitation and marketing, as contemplated by the JOBS Act" (the "**JOBS Act Relief Letter**").

Under the Final Rules, the CFTC has adopted amendments to Regulations 4.7(b) and 4.13(a)(3) that are consistent with the JOBS Act and informed by the exemptive relief previously provided by the JOBS Act Relief Letter.

The Release noted that the CFTC intends for the amendments to Regulations 4.7 and 4.13(a)(3) to supersede the staff exemptive relief previously provided by the JOBS Act Relief Letter. The Release stated that because "CPOs currently relying on that exemptive letter are already required to file notices claiming an exemption under Regulation 4.7 or 4.13(a)(3) to fully utilize that relief, the [CFTC] expects that such exempt CPOs wishing to use general solicitation in their existing qualifying exempt pools may do so without further action. CPOs interested in using general solicitation with respect to qualifying exempt pools formed in the future may do so in accordance with the amendments adopted herein, following their effective date, by filing a notice of exemption for such pools, as required by Regulations 4.7(d) and 4.13(b)(1)."

Permitting Non-U.S. Person Investors in De Minimis Exempt Pools

Regulation 4.13(a)(3) provides a CPO registration exemption to persons who operate pools trading a de minimis amount of commodity interests, subject to the conditions enumerated in that regulation. According to the Release, the Final Rules amend Regulation 4.13(a)(3) to clarify that non-U.S. persons, regardless of their financial sophistication, are permitted participants in pools exempt under this regulation. The Release noted that the Final Rules incorporate by reference the definition of "Non-United States Person" from Regulation 4.7(a). The Release stated that the CFTC "believes that this amendment provides an important update to this exemption, which reflects the general market understanding and practice of permitting non-U.S. persons to invest in de minimis pools in a manner consistent with prior [CFTC] statements and staff guidance."

- **See a copy of the Release**

CFTC Adopts Amendments to Commodity Pool Operator and Commodity Trading Advisor Rules for RICs and BDCs, along with the Definition of Reporting Persons

On November 27, 2019, the CFTC issued a release (the "**Adopting Release**") adopting certain amendments to regulations applicable to CPOs and CTAs. According to the Adopting Release, the CFTC adopted the amendments (1) to clarify that the current exclusion from the CPO definition for a registered investment company ("**RIC**") should be claimed by the RIC's investment adviser (as opposed to the RIC itself), and (2) to add an exclusion for the investment advisers of business development companies ("**BDCs**"), which share many operational similarities with RICs. The CFTC also adopted amendments to the "Reporting Person" definition in Regulation 4.27 that would eliminate the filing requirements for Forms CPO-PQR and CTA-PR for certain classes of CPOs and CTAs.

Exclusion from the Definition of CPO

According to the Adopting Release, Section 1a(11) of the Commodity Exchange Act (the "**CEA**") defines the term "commodity pool operator" as any person engaged in a business that is of the nature of a

[2] CFTC Letter No. 14-116 (Sept. 9, 2014).

commodity pool, investment trust, syndicate or similar form of enterprise, and who, with respect to that commodity pool, solicits, accepts, or receives from others, funds, securities, or property, either directly or indirectly, for the purpose of trading in commodity interests. CEA Section 1a(12) defines a "commodity trading advisor" as any person who, for compensation or profit, engages in the business of advising others, either directly or through publications, writings or electronic media, as to the value of the advisability of trading in commodity interests. CEA Section 4m(1) generally requires each person who satisfies the CPO or CTA definitions to register as such with the CFTC, though according to the Adopting Release, the CEA authorizes the CFTC to exclude a person from the definition of a "commodity pool operator", and "commodity trading advisor" by rule or regulation if the CFTC determines that such rule or regulation will effectuate the purposes of the CEA.

In the Adopting Release, the CFTC amended Regulation 4.5 to clarify that the registered investment adviser ("**RIA**") of a RIC would be the person to claim the CPO exclusion on behalf of the RIC. To address timing concerns regarding the regulatory transition for a RIC, if a person other than the RIC's RIA claimed the exclusion, the CFTC noted that under the amended Regulation 4.5, such person would need to allow its exclusion to expire at the time of its annual reaffirmation (i.e., within 60 days of the calendar year-end), and the RIA of the RIC would need to file a new notice prior to such expiration.

The CFTC also adopted amendments to extend the exclusionary relief provided in Regulation 4.5 to the RIAs of BDCs, noting that "because BDCs are subject to SEC oversight comparable to that of RICs, operators of BDCs, i.e., their RIAs, should be subject to the same operational requirements as the operators of RICs." Previously, CFTC staff letters had provided no-action relief to operators of BDCs; however, as noted in the Adopting Release, such no-action letters will be superseded by the amendments, which will become effective 30 days after publication in the *Federal Register*. According to the Adopting Release, RIAs of BDCs should file a notice to claim the exclusion under the amended rules as soon as practicable after such amended rules go into effect.

Amendments to the "Reporting Person" Definition

According to the Adopting Release, the CFTC also amended the definition of "Reporting Person" in Regulation 4.27, which defines what types, classes or categories of CPOs and CTAs are required to file Forms CPO-PQR and CTA-PR, respectively. According to the Adopting Release, the amendments would revise the definition by excluding certain registered CPOs and CTAs, building on exemptive relief provided by prior staff no-action letters. Specifically, the amendments would exclude from the definition (1) CPOs that operate only pools for which the CPO has claimed either a definitional exclusion under Regulation 4.5, or an exemption from registration under Regulation 4.13, (2) CTAs that are registered, yet do not direct the trading of any commodity interest accounts, and (3) CTAs that comply with the terms of the registration exemptions contained in Regulation 4.14(a)(4) or 4.14(a)(5), yet are nevertheless registered as CTAs.

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

Industry Update

SEC Director Dalia Blass Delivers Keynote Address at 2019 ICI Securities Law Developments Conference

On December 3, 2019, Dalia Blass, the Director of the SEC's Division of Investment Management (the "**Division**"), delivered the keynote address at the 2019 ICI Securities Law Developments Conference. Blass began her remarks by reflecting on the Division's accomplishments on the rulemaking front during the past year, which included the adoption of rules related to exchange-traded funds ("**ETFs**") and standards of conduct relating to broker-dealers and investment advisers, as well as rule proposals relating to investment adviser advertising and solicitation, derivatives use by registered funds, variable annuity disclosure, funds of funds, and securities offering reform. According to Blass, the Division had

several other notable accomplishments, which included a successful recommendation to the SEC of an exemptive order for a new model of actively managed ETFs, continued board outreach and investor experience initiatives, extension of the crucial MiFID II no-action letter, and guidance on the use of client commission arrangements.

Blass then outlined the topics for her address: fund innovation, modernization of regulations and updates to the fund disclosure regime.

Fund Innovation

Blass stated that the Division is focused on balancing its support for innovation in the investment funds industry with the need for proper investor protection in the face of industry innovation. To that end, Blass emphasized two examples of how the Division navigated such balancing act with fund sponsors: (i) the registration of a closed-end interval fund that will invest in bitcoin futures and (ii) a new model of actively managed ETFs.

Digital Assets and Related Investments

Blass continued by referencing a 2018 letter she issued where she called upon the fund industry "to engage in a dialogue on the investor protection and substantive issues" presented by investments related to digital assets. The letter, which focused on issues such as valuation, custody, liquidity, the efficiency of the arbitrage mechanism for ETFs and potential manipulation in the digital asset markets, called on funds seeking to invest in digital assets to consider the aforementioned issues before filing a registration statement.

According to Blass, the industry provided constructive input to this dialogue, and as a result, one registered closed-end interval fund with a bitcoin futures strategy is now preparing to launch. According to Blass, the fund provided thoughtful responses to each of the issues Blass identified in the letter referenced above; nevertheless, Blass reminded the audience that no investment products are without risk–a maxim that is "particularly true with novel and previously-untested investment strategies." Thus, Blass reminded the audience that "investors should proceed with caution, ask questions, and consider their risk tolerance before investing."

ETFs

Blass continued by underscoring the progress made in 2019 on the ETF front. Blass highlighted, in addition to the new ETF rule adopted by the SEC--which, according to Blass, creates a level playing field for the vast majority of ETFs today and will foster innovation in the marketplace--SEC authorization for the first new actively managed ETF model since 2008, and recent exemptive order notices for another four actively managed ETF models.

According to Blass, these models are novel because they will provide information to the market without exposing the underlying ETF portfolio decisions. According to Blass, while each of the models would pursue a different method of shielding the ETF manager's strategy, each model would nevertheless provide sufficient information about the portfolio's value to enable arbitrage.

Modernization of Regulations

Blass continued by reiterating one of the Division's major themes: the modernization of outdated rules. She indicated that, as part of this focus, specific efforts are being made to modernize regulation of registered funds' use of derivatives and affiliated securities lending.

Registered Funds' Use of Derivatives

Blass underscored her belief that updating and modernizing existing regulatory regimes that are out-of-date is a critical function of the Division. According to Blass, the derivatives market is an area where registered funds have needed to rely on a "patchwork of instrument-by-instrument guidance and no-action positions" in the face of expansion and diversification. Thus, in what Blass referred to as an "important

step forward," the SEC unanimously voted to propose new rulemaking aimed at addressing registered funds' use of derivatives and leveraged funds. See Davis Polk's **Client Alert** dated November 27, 2019, which outlines the key provisions of the proposed new rule.

Blass sought feedback on certain aspects of the proposed rule, including the following:

- Whether the proposed rule's approach to oversight by a registered fund's board effectively leverages and empowers the board, and provides the board with the information and tools it needs to oversee the fund's use of derivatives.
- Whether the proposed rule's use of a value-at-risk ("**VaR**")-based test establishes an effective limit on fund leverage risk and addresses potential limitations of the VaR-based test.
- Whether there are any benefits to retaining a separate asset segregation requirement for derivatives transactions, which is not featured in the proposed rule.
- Whether the proposed rule and proposed new sales practice requirements with respect to leveraged and inverse ETFs appropriately address the unique risks presented by such ETFs.

Affiliated Securities Lending

Blass continued by emphasizing another subject matter where regulation modernization is an important goal: affiliated securities lending. According to Blass, fund advisers may be using related revenue to boost their returns or to reduce the impact of expenses. Blass indicated that funds generally use a securities lending agent in order to support their lending programs, and the agent may be an affiliate. Blass noted that such funds may pay the lending agents in a variety of ways, including on a fee-for-service basis or by sharing securities lending revenue. In any case, according to Blass, registered funds that pay an affiliated agent with a share of revenue must obtain exemptive relief from the SEC.

According to Blass, the SEC last issued an exemptive order providing such relief in 2004, creating a divide between firms that do and do not have access to such relief. She indicated that the SEC is reviewing securities lending in order to address this divide, and in doing so must confront the potential conflicts of interest issues and abuses raised by such arrangements.

Fund Disclosure

Blass continued by returning to a topic at the heart of the SEC's "Investor Experience Initiative": fund disclosure. According to Blass, the next major step in the Investor Experience Initiative is the streamlining of the shareholder report. Blass also highlighted two other important areas in the SEC's initiative: fund fee disclosure and foreign index risk disclosure.

Fund Fee Disclosure

According to Blass, investors have indicated that fee disclosures need attention, and investor concerns are best summarized in a single question: "How much of my money is working for me?" Blass noted that the SEC staff is considering ways of updating fee disclosures to answer this question and reiterated her concern that current requirements are not keeping pace with changing market practices. For example, she noted that the Division is considering whether funds that advertise zero fees should provide explanations and qualifications so as not to be misleading.

Disclosure Issues for Funds Tracking Foreign Indices

Blass continued by noting that the Division also focuses on concerns such as improving risk disclosures. According to Blass, while the Division recently published suggestions for improving risk disclosures, there continues to be room for improvement. Specifically, Blass highlighted funds that track indices with significant exposure to emerging and frontier markets, which face unique risk disclosure considerations, and noted that the staff has heightened its review of such disclosures.

In some foreign markets, Blass noted, less information is publicly available. According to Blass, such markets may also involve less oversight of compliance with regulatory and reporting requirements. As a result, Blass noted that "there may be heightened risks associated with the adequacy and reliability of the information index providers use when constructing their indices." Moreover, Blass indicated that there may also be "a marked difference in the rights and remedies available to a fund against index constituents located in emerging and frontier markets compared to the rights and remedies available in the United States."

Blass noted that funds should consider the potential risks to the reliability of index data, index construction and index computation, which can affect fund performance, by asking questions such as the following:

- "What are the risks in using unreliable or outdated information when assessing if a constituent should be included in an index?"
- "What if the issue is not just the quality of the information, but that the index provider has access to partial or very limited information?"
- "What are the limitations, if any, in assessing the index provider's due diligence process?"
- "What are the limitations, if any, to the rights and remedies available to the fund?"

Closing

Blass closed her remarks by reiterating the importance of the services provided by asset managers and fund sponsors, which are "critical to investors, our markets, and our economy." As a result of that importance, Blass re-emphasized the necessity of rule modernization in providing proper safeguards to accompany increased investor choices and opportunities.

- **See a transcript of the remarks**

Litigation

SEC Settles Charges against Investment Adviser and CEO for Failure to Follow Client Instructions

On December 10, 2019, the SEC issued an order (the "**KCM Order**") instituting and settling cease-and-desist proceedings against Kornitzer Capital Management, Inc. ("**KCM**"), a registered investment adviser, and its President, CEO and majority owner John C. Kornitzer, for failing to follow client instructions and adopt or implement reasonably designed written policies and procedures connected to client objectives and restrictions.

The KCM Order states that KCM served as an investment adviser, and that Kornitzer served as portfolio manager, for four collective investment trusts ("**CITs**"). The CITs were investment vehicles sponsored by Trust Company ("**TC**"). The SEC alleged that Kornitzer began making large investments for the CITs in the debt and equity securities of "Company A," a NYSE-listed company. By December 2015, Company A's securities made up 30% of the assets of two of the CITs, 79% of the assets of a third CIT and 89% of the assets of the fourth CIT.

In February 2016, the SEC alleges, the TC board of directors directed KCM to develop a plan to reduce the concentrations of Company A securities in the CITs to 10%. In February 2016, KCM and Kornitzer told TC's board members that KCM and Kornitzer would reduce the concentration in Company A's securities to 10% within 12 to 18 months, depending on market conditions. Although KCM took steps to reduce concentrations in Company A's securities during 2016, concentrations remained above the 10% limit. At various times in 2017, the TC board requested that KCM develop a plan to bring concentrations of Company A's securities into compliance with concentration limits. In February 2018, KCM adopted a

compliance policy requiring that investments be consistent with client objectives and restrictions. However, by June 2018, KCM had not yet reduced concentrations in Company A's securities to 10% or below. In August 2018, at the request of TC's board, Kornitzer agreed to step down as the CITs' portfolio manager. According to the KCM Order, the CITs incurred significant financial losses following a steep drop in Company A's stock price in 2018.

As a result of the conduct described above, the SEC found that KCM willfully violated Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-7 thereunder. The KCM Order further found that Kornitzer willfully violated Section 206(2) of the Advisers Act and caused KCM's violation of Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder. KCM and Kornitzer agreed to be censured, to the entry of the KCM Order, to cease and desist from future violations, and to a joint and several penalty of $2.7 million. KCM additionally agreed to pay disgorgement and prejudgment interest totaling $5,059,118; the SEC noted that in December 2018—after the SEC investigation had commenced—KCM had reimbursed the CITs for approximately $4,132,132 of the losses that the CITs incurred as a result of the drop in value of Company A's securities, and deemed that amount of the disgorgement to be paid.

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

SEC Settles Charges against Investment Adviser Regarding Allocation of Block Trading Costs

On November 22, 2019, the SEC issued an order (the "**Channing Capital Order**") instituting and settling cease-and-desist proceedings against Channing Capital Management, LLC ("**Channing**"), a privately held investment management firm, for allegedly failing to implement written policies and procedures governing the allocation of trading commission costs associated with block securities trades on behalf of its clients.

According to the SEC's order, between January 2014 and January 2018, Channing offered U.S. domestic equity investment portfolio products to institutional investors and pension funds (collectively, "**Clients**"). Channing had discretion to buy and sell equity securities on behalf of its clients, subject to a number of client-imposed mandates, requirements and restrictions set forth in investment management agreements and accompanying investment and trading guidelines and restrictions. In accordance with Rule 206(4)-7 under the Advisers Act, Channing prepared and adopted a set of written compliance and supervisory policies and procedures. Under Channing's written trade aggregation and allocation policies and procedures, Channing was required to "allocate the transaction costs associated with block trades on a *pro rata* basis amongst all clients participating in the same block trade." A separate written policy and procedure required Channing to follow the "requirements and restrictions set forth in each client's investment management agreement," which included following client limitations on trading commissions. Four (out of approximately 35-45) of Channing's institutional Clients placed limitations on the amount that those Clients were willing to pay in commission rates for execution of their brokerage transactions. These Clients restricted the commission rate to no more than $0.03 to $0.035 per share, while the remaining Clients did not specify, or otherwise limit, the commission rate they were willing to pay.

The SEC alleged that, between January 2014 and January 2018, Channing would "routinely" aggregate the trades of Clients who restricted commission rates with the trades of Clients who did not impose those same restrictions, by conveying the restrictions to executing brokers and requesting that the brokers apply lower commission rates for the Clients who had imposed the restrictions. The brokers would routinely agree to limit the commissions charged to those specific Clients, while charging Channing's other Clients a higher commission rate. According to the SEC, this practice resulted in certain block trades in which certain clients would pay commission rates of $0.04 per share, while Clients who had imposed limitations on maximum commission rates paid only $0.03 or $0.035 per share as part of the same trade. While Channing disclosed to its Clients that it would observe their investment mandates and

restrictions, it failed to disclose that some clients in certain block trades would pay a lower commission rate than other Clients who participated in the same trade.

As a result of the conduct described above, the SEC found that Channing violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder. The Channing Capital Order notes that Channing “promptly” undertook “voluntary remedial acts,” including changing its practices to avoid charging different commission rates, and later obtaining Client permission to either deviate from maximum commission rates or to remove trades from a block trade so that Clients participating in that trade would be charged the same price and commission rate. Without admitting or denying the findings in the SEC’s order, Channing agreed to be censured, to cease and desist from committing or causing any future violations and to pay a civil monetary penalty of $50,000 to the SEC.

- **See a copy of the Channing Capital Order**

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your usual 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**
Sarah E. Kim	212 450 4408	**sarah.e.kim@davispolk.com**
Marc J. Tobak	212 450 3073	**marc.tobak@davispolk.com**

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