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CLIENT NEWSLETTER

Investment Management Regulatory Update

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Industry Update

SEC Announces Cybersecurity Enforcement Initiatives

On September 25, 2017, the SEC issued a press release announcing two new initiatives to further ongoing cyber-related enforcement efforts: (i) a Cyber Unit that will focus on targeting cyber-related misconduct and (ii) a Retail Strategy Task Force that will implement initiatives directly affecting retail investors.

According to the press release, the Cyber Unit will include staff from across the SEC's Enforcement Division and will target cyber-related misconduct such as market manipulation schemes conducted via electronic and social media, hacking to obtain material nonpublic information, violations involving initial coin offerings and threats to critical market infrastructure.

According to the press release, the Retail Strategy Task Force will leverage technology and data analytics from past enforcement actions to develop initiatives aimed at identifying large-scale misconduct that impacts retail investors.

- See a copy of the Press Release

SEC Chairman Issues Statement on Cybersecurity

On September 20, 2017, SEC Chairman Jay Clayton released a public statement (the "**Statement**") outlining the SEC's approach to identifying and managing cybersecurity risks.

Clayton began by discussing the three types of data the SEC collects: (i) public-facing data, which is transmitted to and accessed through SEC systems such as EDGAR; (ii) nonpublic data related to issuers, broker-dealers, investment advisers, investment companies and other market participants, which is collected in connection with the SEC's ongoing supervisory and enforcement functions; and (iii) nonpublic data related to the SEC's internal operations, which include records of internal investigations, risk management data and internal memoranda, among other things.

Next, Clayton described the cybersecurity risks faced by the SEC, including risks of external cyber threat actors compromising EDGAR user credentials, making fraudulent filings and accessing nonpublic data on enforcement actions and illegally profiting from them. Further, Clayton pointed to potential unauthorized actions or disclosures by SEC personnel and weaknesses in third-party vendor systems. To combat these threats, Clayton outlined an agency-wide cybersecurity program that includes the following key aspects:

- *Governance*. Clayton noted that SEC commissioners and senior management are required to coordinate their cybersecurity efforts through risk reporting and the development and testing of agency-wide procedures. The SEC Office of Information Technology has overall management responsibility for the cybersecurity program, which is periodically assessed internally and by impartial third parties.
- *Policies and procedures*. According to Clayton, the SEC has established internal cybersecurity policies and procedures that detail the roles and responsibilities of various SEC officials, offices, committees and system owners. The SEC is also in the process of implementing the National Institute of Standards and Technology's Framework for Improving Critical Infrastructure Cybersecurity.
- *Independent audits and reviews*. According to Clayton, the SEC's cybersecurity program is also periodically reviewed by internal and external independent auditors, including the Office of Inspector General and the Government Accountability Office.
- *External reporting*. According to Clayton, the SEC has established protocols for submitting cybersecurity performance reports to the Office of Management and Budget, and privacy and cybersecurity incidence reports to the Department of Homeland Security. Information on cybersecurity is also shared with other external institutions such as the National Cybersecurity and Communications Integration Center and the Financial and Banking Information Infrastructure Committee.

Clayton then focused on the SEC's efforts to incorporate cybersecurity considerations into its existing disclosure and supervisory programs. According to Clayton, these efforts include:

- *Guidance on effective public company disclosures*. Clayton noted that as the SEC's primary role in regulating U.S. public company issuers is disclosure-based, the Division of Corporation Finance has issued guidance aimed at helping companies consider how cybersecurity disclosures should be included in their public reports. Such guidance includes a discussion of cybersecurity considerations relevant to a company's risk factors, management's discussion and analysis of financial condition and results of operations, description of business, discussion of legal proceedings, financial statements and disclosure controls and procedures.
- *Oversight of market infrastructure*. According to Clayton, in an effort to bolster the technology infrastructure of U.S. securities markets, the SEC adopted in 2014 Regulation Systems Compliance and Integrity and Form SCI, which require "SCI entities" (including self-regulatory organizations such as stock and options exchanges, certain alternative trading systems, disseminators of consolidated market data and certain exempt clearing agencies) to (i) maintain policies and procedures reasonably designed to ensure operational resiliency and (ii) take corrective action and notify the SEC when system disruptions, compliance issues and intrusions such as cybersecurity breaches occur. In addition, SCI entities are subject to examination by the Office of Compliance Inspections and Examinations ("**OCIE**").
- *Oversight of market participants*. According to Clayton, the SEC has issued a number of regulations that directly implicate cybersecurity practices in regulated entities such as broker-dealers, investment advisers, investment companies, credit rating agencies and other market

participants. Such regulations include Regulation S-P, which requires registered broker-dealers, investment companies and investment advisers to adopt written policies and procedures to facilitate the protection of customer information and records, as well as Regulation S-ID, which requires the same firms to establish programs aimed at identifying, detecting and responding to potential identity theft red flags for certain covered accounts. Clayton further noted that compliance with the foregoing regulations has been a focus of OCIE examinations of registered entities.

With respect to broad and potentially systemic cybersecurity risks, Clayton noted the SEC's focus on coordinating with other U.S. and non-U.S. regulatory agencies that share oversight responsibilities. Clayton also warned that failure by market participants to take their cybersecurity obligations seriously may result in enforcement actions, as the SEC is not limited to using its enforcement authority against those engaging in illegal cyber activity.

- **See a copy of the Statement**

ESG in Private Equity: What Every GP Needs to Know About Public Pension Fund Requirements

Public pension funds have long been outspoken advocates of environmental, social and governance ("**ESG**") principles in investing. As quasi-public institutions uniquely sensitive to public opinion and the political process, public pension funds have begun to incorporate ESG considerations into all asset classes in their portfolio, including their private equity investments. With public pension fund limited partner ("**LP**") investments constituting 44% of total worldwide private funding by the top 100 LPs in private equity—the largest category of private equity LP type by far among the top 100—it is important that private equity firms understand the ESG expectations of public pension funds and assess on an ongoing basis whether their ESG policies and practices, and those of their portfolio companies, are responsive.

In a **recent memo**, we review ten North American public pension funds with some of the largest stakes in private equity and describe how public pension funds integrate their ESG policies in LP investments with private equity funds.

Litigation

SEC Charges Adviser with Improperly Recommending Higher Fee Mutual Funds

On September 14, 2017, the SEC issued an order (the "**Order**") instituting and settling administrative and cease-and-desist proceedings against a dually registered investment adviser and broker-dealer (the "**Adviser**") for improperly recommending, purchasing or holding more expensive classes of mutual fund shares for advisory clients when less expensive share classes of the same mutual funds were available.

According to the Order, from late 2011 to mid-2015, the Adviser offered its advisory clients the option of investing through wrap fee advisory programs in a broad range of mutual funds across numerous complexes. In all such programs, advisory clients were eligible to invest in "Class A" shares or "Class I" shares of the available mutual funds. According to the Order, while "Class I" shares typically do not charge marketing and distribution fees ("**12b-1 fees**"), "Class A" shares often carry 12b-1 fees of as much as 25 basis points per year for an advisory client. Such 12b-1 fees are generally paid by a mutual fund out of fund assets and paid to broker-dealers and registered representatives whose customers invest in the shares. The Adviser, in its capacity as a broker-dealer, would be paid 12b-1 fees in connection with any "Class A" shares held by its advisory clients and would pass on a portion of such fees to its investment adviser representatives ("**IARs**").

According to the Order, despite the fact that it was in the clients' best interests to select "Class I" shares over "Class A" shares, the Adviser's IARs routinely purchased, recommended or held "Class A" shares for advisory clients. The Order alleged that the Adviser and its IARs received at least $1,148,071.77 in avoidable 12b-1 fees, which decreased the value of the advisory clients' investments in the mutual funds. Further, according to the Order, the Adviser stated in its Form ADV Part 2A brochures that it "may" receive 12b-1 fees as a result of investments in certain mutual funds and that such fees presented a "conflict of interest," but did not disclose that (i) the Adviser was actually receiving 12b-1 fees throughout its advisory programs, (ii) available mutual funds also offered share classes that did not charge 12b-1 fees and (iii) IARs sometimes did select or recommend share classes that paid 12b-1 fees even when clients were eligible to invest in less expensive share classes. According to the Order, this disclosure did not adequately inform the Adviser's clients of the conflicts of interest faced by the Adviser and its IARs. Further, the Order stated that the Adviser did not update its compliance policies and procedures to require IARs to identify or evaluate available "Class I" shares or enhance existing policies and procedures to address instances where IARs were recommending "Class A" shares when "Class I" shares were also available.

According to the Order, as a result of the conduct described above, the Adviser breached its fiduciary duty to seek best execution for client transactions and also violated (i) Section 206(2) of the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"), which generally prohibits an investment adviser from engaging in any transaction, practice or course of business that operates as a fraud upon any client or prospective client, (ii) Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which generally require investment advisers to, among other things, adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules and (iii) Section 207 of the Advisers Act, which generally prohibits any person from willfully making any untrue statement or omission of material fact in any registration application or report filed with the SEC.

The Adviser consented to the entry of the Order without admitting or denying the findings and agreed to pay disgorgement of $34,560.93 and prejudgment interest of $4,950.66. The Order noted that the SEC considered remedial acts undertaken by the Adviser in accepting the Adviser's offer of settlement, including its voluntary reimbursement of $918,343.93, including interest, to 2,720 existing client accounts, the review and conversion of existing Class A shares to the most cost effective share class available to its clients and the issuance of new compliance guidance requiring IARs to recommend or purchase the most cost effective mutual fund share class available.

- **See a copy of the Order**

SEC Charges Large Financial Institution With Hidden Fee Markups and Disclosure Failures

On September 7, 2017, the SEC issued an order (the "**First Order**") instituting and settling administrative and cease-and-desist proceedings against a large bank (the "**Bank**") and two affiliated broker-dealers (collectively, the "**Financial Institution**") in connection with an alleged scheme to defraud transition management customers by charging those customers hidden and unauthorized mark-ups and commissions. On the same day, the SEC also issued an order (the "**Second Order**") instituting and settling administrative and cease-and-desist proceedings against the Bank for failing to disclose the availability of a "Last Look" functionality on its electronic trading platform for U.S. treasury securities.

The First Order

According to the First Order, the Financial Institution is a provider of transition management services, which are typically provided to institutional customers (such as pension funds or investment managers) that are changing fund managers or investment strategies and face large and complex changes to their asset portfolios. Transition management services are often sought to ensure that the transition is conducted at the lowest overall cost, which includes both performing the transition in a way that does not adversely impact market prices and limiting the transition management provider's commissions, mark-ups and fees.

According to the First Order, from February 2010 to September 2011, the Financial Institution and certain of its former employees carried out a scheme to defraud six transition management customers by charging those customers hidden and unauthorized mark-ups and commissions beyond the fees, mark-ups and commissions that the customers had agreed to pay on trading in U.S. and European securities. According to the First Order, the Financial Institution had secured each of these engagements by agreeing with the customer that no commissions would be charged on the customer's side of trades. However, based on taped conversations and email communications among former employees of the Financial Institution, the SEC alleged that such former employees had planned from the start to charge the customer a few basis points of undisclosed mark-ups on the trades. According to the Order, the fraudulent scheme was carried out by: (i) specifically instructing traders via phone to charge commissions even when they received written trading instructions to the contrary, (ii) booking trades through an average pricing trading account in which commissions were added to equity trades before booking out customer prices, so that such commissions would not be visible in customer reports that showed only net prices on a trade-by-trade basis and (iii) disguising mark-ups within broader categories called "bid-offer" spread, "bid-ask" spread or "market impact" costs in the pre- and post-trade analysis reports provided to customers.

According to the First Order, one customer had specifically raised the question of whether the Financial Institution was only taking its pre-negotiated fee when such customer's consultant, using publicly available bond pricing information, identified mark-ups on certain U.S. fixed income trades. When the customer sought confirmation from the Financial Institution, however, it was informed that a one basis point mark-up on its U.S. trades had been charged but was an inadvertent error (but was not informed that a one basis point mark-up had also been charged on the customer's European trades).

According to the First Order, as a result of the conduct described above, which caused six transition management customers to be overcharged by approximately $20 million, the Financial Institution willfully violated Sections 17(a)(1) and 17(a)(3) of the Securities Act of 1933 (the "**Securities Act**") and Section 10(b) of the Securities and Exchange Act of 1934 and Rules 10b-5(a) and (c) thereunder, which prohibit fraudulent conduct in the offer or sale of securities and in connection with the purchase or sale of securities.

The Financial Institution consented to the entry of the First Order without admitting or denying the findings. After the conduct was discovered, the Financial Institution contacted the six affected customers and voluntarily refunded all undisclosed mark-ups and commissions. In addition, pursuant to the First Order, the Financial Institution undertook to retain a qualified independent ethics and compliance consultant to review and evaluate the Financial Institution's compliance and ethics program, culture, policies and controls relating to the disclosure of fees and other compensation, statements to customers and accounting. The SEC also ordered the Financial Institution to pay a civil money penalty in the amount of $32.3 million.

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

The Second Order

According to the Second Order, the Bank, which provides asset servicing such as custody and accounting to institutional clients, developed an electronic platform called "GovEx" in late 2008 that would allow non-dealers to trade U.S. treasury securities. According to the Second Order, the Bank offered incentives to certain subscribers to act as market makers and provide liquidity on the platform. One such subscriber (the "**Last Look Subscriber**") was offered a "Last Look" functionality for its account, which gave this subscriber a short period of time in which to reject a match to a quote that it had submitted on GovEx. From July 2010 through October 2010, according to the Second Order, the Bank connected this Last Look Subscriber's account to most other subscriber accounts that were trading on GovEx at that time without informing these other subscribers that they had been connected to an account that could reject matched quotes. The Second Order alleged that the Last Look Subscriber rejected 57 of the 157 matches to quotes placed by its account, and the counterparties to the rejected matches were not informed that their orders had been rejected with the use of “Last Look.” In addition, according to the Second Order, the various marketing materials and information materials provided to subscribers during the relevant period did not disclose that “Last Look” was being developed and, when another subscriber specifically inquired whether there was “Last Look” on GovEx in May 2010, the Bank represented that there was no “Last Look” or similar functionality on GovEx.

According to the Second Order, as a result of the conduct described above, the Bank violated Section 17(a)(2) of the Securities Act, which generally prohibits, in the offer or sale of securities, obtaining money or property by means of an untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.

The Bank consented to the entry of the Second Order without admitting or denying the findings and agreed to pay a civil money penalty in the amount of $3 million.

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

SEC Charges Private Equity Fund Adviser and Principal for Improper Allocation of Expenses

On September 11, 2017, the SEC issued an order (the “**PAMCO Order**”) instituting and settling administrative and cease-and-desist proceedings against Potomac Asset Management Company Inc., an investment adviser registered with the SEC (“**PAMCO**”) and Goodloe E. Byron, Jr., its principal (“**Byron**” and, together with PAMCO, the “**PAMCO Parties**”) for improperly allocating certain fees and expenses to two private equity fund clients, Potomac Energy Fund, L.P. (“**Fund I**”) and Potomac Energy Fund II, L.P. (“**Fund II**” and, together with Fund I, the “**Funds**”).

According to the PAMCO Order, PAMCO provides investment advisory and management services to the Funds. The Funds’ limited partnership agreements (“**LPAs**”) provided that PAMCO would be responsible for paying its own operating expenses, including overhead, employee compensation, office rent and regulatory expenses. In addition, the LPAs stated that while PAMCO was entitled to receive an annual management fee from the Funds, such management fee would be offset by a specified percentage of PAMCO’s other income, including consulting and other fees received from portfolio companies.

According to the PAMCO Order, between 2012 and 2013, the PAMCO Parties improperly allocated to Fund I $2.2 million in fees for services to a portfolio company without authorization to do so in the LPAs, and failed to disclose the misuse of fund assets to Fund I’s limited partners. Further, the PAMCO Order alleged that after the relevant portfolio company reimbursed these fees, PAMCO failed to offset the fees against management fees in accordance with the LPA, which resulted in PAMCO collecting $726,000 more than it should have received. In addition, the PAMCO Order alleged that between 2012 and 2015, the PAMCO Parties improperly used the Funds’ assets to pay $703,835 in adviser-related expenses, which was expressly prohibited by the LPAs. These expenses included compensation to a member of PAMCO’s investment team, office rent and operational expenses, and costs incurred during examinations by the OCIE and the SEC’s Enforcement Division. According to the PAMCO Order, PAMCO’s Form ADV for 2012 through 2014 failed to disclose that these expenses had been charged to the Funds.

According to the PAMCO Order, PAMCO also failed to disclose the transactions described above, which constitute related party transactions for purposes of GAAP, in the Funds’ audited financial statements. As a result, such financial statements were not prepared in accordance with GAAP and PAMCO, which had custody of client assets as an investment adviser, was not entitled to rely on Rule 206(4)-2(b)(4) of the Advisers Act, which provides a limited exception to Rule 206(4)-2 (the “**Custody Rule**”) for advisers to pooled investment vehicles that provide limited partners with GAAP-compliant financial statements within

120 days of the end of each fiscal year. According to the PAMCO Order, the Funds' audited financial statements also failed to be compliant with the Custody Rule because they were not distributed to the Funds' partners within the required 120-day period.

Finally, according to the PAMCO Order, the SEC found that PAMCO failed to implement written policies and procedures to prevent violations of the Advisers Act. The PAMCO Order alleged that, from 2012 to 2014, PAMCO's compliance manual did not include policies and procedures that addressed allocation of expenses between PAMCO and the Funds, Byron's control of related parties and how that control might affect related party transactions, and required disclosures. Moreover, according to the PAMCO Order, Byron, as the owner and controlling person of the general partner of both Funds, failed to make timely capital contributions to the Funds as required under the LPAs, which failure was not adequately disclosed to the Funds' limited partners.

According to the PAMCO Order, as a result of the conduct described above, the PAMCO Parties willfully violated (i) Section 206(2) of the Advisers Act; (ii) Section 206(4) of the Advisers Act and Rule 206(4)-8 promulgated thereunder, which make it unlawful for any investment adviser to a pooled investment vehicle to make any untrue statement of a material fact or to omit to state a material fact necessary to make the statement made not misleading or to engage in any fraudulent, deceptive or manipulative act with respect to any investor or prospective in the pooled investment vehicle; (iii) Section 206(4) of the Advisers Act and Rule 206(4)-7 promulgated thereunder and (iv) the Custody Rule.

The PAMCO Parties consented to the entry of the PAMCO Order without admitting or denying the findings and agreed to pay a civil money penalty of $300,000. The PAMCO Order noted that the SEC considered remedial acts undertaken by PAMCO, including voluntarily reimbursing the Funds for the improperly allocated expenses and excess management fees discussed above (including interest), hiring a new Chief Compliance Officer and engaging an independent compliance consultant, in accepting the offer of settlement.

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

SEC Charges Investment Adviser with Disclosure Failures Relating to 'Broken Deal' Expenses

On September 21, 2017, the SEC issued an order (the "**Platinum Order**") instituting and settling administrative and cease-and-desist proceedings against Platinum Equity Advisors, LLC, an investment adviser registered with the SEC ("**Platinum**") for causing its three main private equity funds (the "**Platinum Funds**") to bear broken deal expenses that benefited co-investors without disclosing to fund investors that they would bear co-investors' expenses.

Like many private equity funds, co-investors—according to the Platinum Order, "typically officers, directors, executives, and employees of Platinum"—invested alongside the Platinum Funds. The limited partnership agreements of the Platinum Funds required that each fund "bear and be charged with all expenses of the [p]artnership other than [g]eneral [p]artner [e]xpenses." The Platinum Funds' private placement memoranda stated that each fund would "pay all expenses related to its own operations." The limited partnership agreements and private placement memoranda did not disclose that Platinum Funds would bear broken deal expenses for the portions of investments that would have been allocated to co-investors.

According to the Platinum Order, from 2004 to 2015, the Platinum Funds invested $5.3 billion in 85 companies. Over the same period, co-investors invested approximately $728 million in these same companies through Platinum-managed co-investment vehicles. The Platinum Order alleged that despite the incurrence of significant broken deal fees and the absence of disclosure stating that all broken deal expenses would be borne by the Platinum Funds, Platinum did not allocate any broken deal expenses to its co-investors, which had also participated in Platinum's successful transactions. According to the Platinum Order, this resulted in the Platinum Funds being allocated $1,811,501 more in broken deal expenses from Q2 2012 to 2015 than they should have. Further, according to the Platinum Order, Platinum's allocation of broken deal expenses benefiting co-investors affiliated with Platinum also operated as an undisclosed conflict of interest between Platinum and the investors in the Platinum Funds. Finally, the Platinum Order stated that Platinum had failed to adopt and implement a written compliance policy or procedure governing the allocation of broken deal expenses.

According to the Platinum Order, as a result of the conduct described above, Platinum violated (i) Section 206(2) of the Advisers Act and (ii) Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder. Platinum consented to the entry of the Platinum Order without admitting or denying the findings and agreed to pay a total of $1,902,132, consisting of $1,708,388 in disgorgement and $193,744 in prejudgment interest, as well as a $1.5 million civil money penalty.

The Platinum Order highlights three key points for private equity advisers:

- First, it is clear that the SEC remains focused on situations presenting potential or actual conflicts of interest between private equity advisers and the investors in their managed funds. Numerous enforcement actions over the past three years demonstrate that the SEC will carefully scrutinize an adviser's allocations of investments, fees, and expenses and take remedial action when the SEC staff believes that the adviser may have acted contrary to investors' best interests.
- Second, in light of these settlements, private equity advisers should (i) adequately disclose to prospective investors potential conflicts of interest, including how fees, expenses, and benefits will be allocated among managed funds, the manager, and any co-investors; and (ii) adopt precisely described policies and procedures regarding investment, fee, and expense allocation, and ensure that the policies are followed through a robust compliance program.
- Third, the Platinum Order notably does not indicate that Platinum discovered the allocation issue on its own initiative, or made efforts to remedy the misallocation (for example, by refunding the funds for the co-investors' portion of expenses). The penalty Platinum agreed to pay is about 79% of the total amount disgorged, which is somewhat higher than average and notably higher than other enforcement actions in which the charged adviser voluntarily refunded investors the amount that the SEC believed to have been misallocated.

► **See a copy of the Platinum Order**

California State Court Holds ETF Shareholders Subject to Section 11 Tracing Requirement

On September 18, 2017, in a case of first impression, the Superior Court of California held that the shareholders of exchange-traded funds (ETFs) may sue under Section 11 of the Securities Act ("**Section 11**") only if plaintiffs can trace their holdings to shares sold pursuant the registration statement containing the alleged misstatements or omissions. *Jensen v. iShares Trust*, No. CGC-16-552567, 2017 Cal. App. LEXIS 831 (Cal. Sup. Ct., San Francisco Cty., September 18, 2017). The *Jensen* decision appears to be the first decision to address whether ETF shareholders are subject to the "tracing" requirement that courts have generally applied to claims under Section 11.

The *Jensen* suit arises out of the 2015 "flash crash," during which rapid, temporary price moves in ETFs triggered stop loss orders that resulted in disproportionate losses for investors in certain ETFs. On August 24, 2015, 19.2% of all ETFs experienced drastic price declines of more than 20%, while the underlying corporate securities experienced an average 4.7% price decline. Plaintiffs alleged that certain registration statements relating to BlackRock's iShares unit were materially false or misleading because they failed to adequately disclose the risks associated with ETFs and stop loss orders.

Section 11 provides a cause of action for purchasers of a security based on a materially false or misleading registration statement. Courts have interpreted Section 11 to require that the purchaser trace the purchased shares directly back to the offering covered by the allegedly false or misleading registration statement. The "tracing" requirement is generally an obstacle to bringing Section 11 claims with respect to securities that have been issued under multiple registration statements, but, as the Ninth Circuit has stated, tracing "is the condition Congress has imposed for granting access to the 'relaxed liability requirements' that Section 11 affords." *In re Century Aluminum Co. Sec. Litig*., 729 F.3d 1104, 1107 (9th Cir. 2013).

Unlike traditional issuers, ETFs typically engage in a continuous offering of "Creation Units"—large blocks of shares—to institutional market participants, who sell the shares into the secondary market. ETFs are required to file annual amendments to their registration statement. Where the allegedly false or misleading language does not vary across registration statements or amendments, the tracing requirement has not presented as significant an obstacle to ETF holders' Section 11 claims. *See*, e.g., *In re Direxion ETF Trust*, 279 F.R.D. 221, 226 (S.D.N.Y. 2012). By contrast, the key issue in *Jensen* is the interaction between the structure of ETF offerings and the Section 11 tracing requirement where certain registration statements contained alleged misstatements or omissions but others did not.

The *Jensen* plaintiffs, who bought ETF shares sold on the open markets, could not trace their shares back to shares issued pursuant to the allegedly false or misleading registration statements. For their part, the *Jensen* plaintiffs pointed to Section 24(e) of the Investment Company Act of 1940, as amended (the "**Investment Company Act**"), which provides that "[f]or the purposes of Section 11 of the Securities Act of 1933, as amended, the effective date of the latest amendment filed shall be deemed the effective date of the registration statement with respect to the securities sold after such amendment shall have become effective." 15 U.S.C. 80a-24(e). According to the plaintiffs, this provision of the Investment Company Act alters Section 11 such that *any* ETF shares sold—whether in a primary offering or on the secondary market—after the effective date of an allegedly defective registration statement should be treated as having been issued pursuant to that most recent amended registration statement.

The *Jensen* court disagreed with the plaintiffs' argument and held that the word "sold" in Section 24(e) of the Investment Company Act refers to an initial offering, not subsequent secondary market purchases, and thus does not change the general rule that Section 11 liability only attaches to shares sold—that is, initially offered—pursuant to an allegedly false or misleading registration statement. Secondary market purchasers of ETF shares may thus sue under Section 11 only if their shares can be traced back to a registration statement containing the alleged misstatements or omissions.

We expect that the *Jensen* decision will not be the last word on this issue, and that its ruling will likely be tested in other courts. As a postscript, *Jensen* also serves as a reminder that state courts have concurrent jurisdiction over claims under the Securities Act, and that, under Section 22(a) of the Securities Act, Securities Act claims brought in state court generally may not be removed to federal court unless the action is a class action subject to removal under the Securities Litigation Uniform Standards Act of 1998.

- **See a copy of the *Jensen* decision**

SEC Brings Action Against Two Companies Related to Initial Coin Offerings

On September 29, 2017, the SEC filed **a complaint** in federal court against REcoin Group Foundation, LLC ("**REcoin**"); DRC World, Inc., also known as Diamond Reserve Club ("**DRC**"); and their principal, Maksim Zaslavskiy. The complaint alleges false and misleading statements and violations of securities laws in connection with initial coin offerings ("**ICOs**") by the two companies.

According to the SEC, the defendants raised funds from hundreds of investors by offering nonexistent digital "tokens" or "coins" supposedly backed by investments in real estate (in REcoin's case) and diamonds (in DRC's case). The SEC further alleges that, in an attempt to evade the registration requirements of the federal securities laws, the defendants marketed the ICOs as sales in club memberships. Further, the SEC's complaint alleges that the defendants made false and misleading statements regarding the amount of capital raised, the investment selection process and the expected investment returns.

According to the SEC, the defendants eventually terminated the REcoin ICO by falsely claiming that the U.S. government required them to do so, when the SEC alleges that Mr. Zaslavskiy himself characterized a token of the nature he had promised as "impossible." The SEC announced that the U.S. District Court for the Eastern District of New York granted an emergency order freezing the defendants' assets.

In a joint statement on REcoin's and DRC's websites, the companies responded:

> "We believe this action is the result of a lack of legal clarity as to when an ICO or a digital asset is a security. This lack of regulatory clarity was implicitly recognized by the SEC in its recent Report of Investigation of the Distributed Organization (the "**DAO Report**"). While we disagree with the SEC's claims that the tokens we sold are securities, and will vigorously defend ourselves, we are cooperating with the SEC in the hope of resolving this issue."

In **the DAO Report**, the SEC concluded that whether a particular transaction constitutes the offer and sale of a security depends on "the facts and circumstances, including the economic realities" of the transaction, "regardless of the terminology used." In a **recent memo**, we examine the DAO Report, the question of when ICO tokens are securities and the broader implications for the token ecosystem.

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.

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