Investment Management Regulatory Update

November 20, 2018

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Rules and Regulations

SEC Proposes Simplified Prospectus Summaries for Variable Annuities and Variable Life Insurance Contracts

On October 31, 2018, the Securities and Exchange Commission (the "**SEC**") issued a proposed set of rules (the "**Proposal**") designed to allow variable annuity and variable life insurance providers to satisfy their disclosure obligations under the Securities Act of 1933, as amended, by providing investors with summary prospectuses, as long as more detailed disclosures are available online or provided in paper format upon request. The Proposal is designed to generally model the framework for mutual fund prospectus summaries adopted by the SEC in 2009.

As part of the Proposal, the SEC has proposed (i) amendments to the registration forms for variable annuities and variable life insurance contracts that would enhance disclosures to investors and implement the proposed prospectus summary framework; (ii) a requirement that variable contracts use the "Inline eXtensible Business Reporting Language" format for certain required disclosures; and (iii) certain technical and conforming amendments to SEC rules and forms, including amendments to rules relating to variable life insurance contracts and rescission of certain related rules and forms.

The SEC is soliciting comments on the proposed rules, which are due by February 15, 2019.

- **See a copy of the Proposal**

Industry Update

Blass Remarks at the Independent Directors Council 2018 Fund Directors Conference

On October 16, 2018, Dalia Blass, the Director of the Division of Investment Management (the "**Division**") of the SEC, gave a speech at the 2018 Fund Directors Conference in Chicago. Blass began by discussing the Division's Board Outreach Initiative, through which the Division has had the opportunity to meet and engage "in an informative dialogue" with a group of fund boards and independent directors over the last year. In her speech, Blass reflected on some of the information that the Division was able to gather from these meetings.

Blass stated that many directors share similar thoughts on what they believe fund boards should be doing and "where they believe existing requirements are not serving investors as well as they should." Many directors discussed three main questions that "help organize their oversight": (i) Are we seeing the quality of service we expect from the fund's service providers?; (ii) Are the costs of the fund reasonable?; and (iii) Is the fund delivering the performance that investors would expect? Blass next discussed the view of many directors, noting that they felt that their role should be to hold management accountable, rather than getting involved in the day-to-day operations of the funds.

Blass next discussed another concern of fund directors: whether they are having the right conversations and whether they are adding the most value they can add. As an example, Blass discussed the requirement for fund boards to make quarterly determinations that "all cross-trades of each fund were made in compliance with the rule." She stated that the fund directors she spoke with did not question "the value of this kind of trade-by-trade determination[,]" but questioned whether "directors are adding the most value when focused on reviewing pages of data for individual trades[,]" when they believe that their time would be better spent on the inquiries that are more likely to reveal problems, such as why the fund is involved in cross-trades, how one fund's activities compare to similar funds in a complex and noteworthy trends. Later in her speech, Blass further discussed the no-action letter which provides an alternative method to compliance with the cross-trading and certain other affiliated-transaction-related rules. For a further discussion of the no-action letter, please see the **October 23, 2018 Investment Management Regulatory Update**. She noted that many directors also reported that they felt it was important for them to track and discuss macroeconomic issues relating to funds and service providers, especially as these issues relate to fund quality, cost and performance.

Blass noted the feedback related to evolving technology as it relates to board functions. She stated that board members have been focused on utilizing technological advancements to improve their effectiveness, for example by integrating virtual conferencing. She further stated that some directors discussed using algorithmic and artificial intelligence technology in order to better analyze trends and large quantities of information that they would be unable to analyze on their own.

Next, Blass discussed the importance of training and education for fund boards. She noted that practical training on topics such as fundamentals of fund operations and governance, important legal requirements, and typical challenging decisions that board members are faced with would be especially valuable as part of continuing education for fund boards.

Blass next added that directors are also seeking clarity from regulators with regard to director responsibilities, "but not at the cost of effectiveness." She stated that fund directors would like more information regarding the principles and theories underlying their responsibilities so that they know how to better apply legal requirements in practice.

In consideration of the above-mentioned feedback from directors, Blass stated that the Division has put together a framework for understanding board responsibilities in order to guide the Division's approach to developing new responsibilities going forward, as well as reevaluating existing obligations. As part of this framework, she noted that the Division will ask the following questions with regard to board responsibilities: (i) Should a given regulatory action require board engagement, and if so, what is the policy goal for the board's involvement; (ii) When the staff recommends board involvement, is it necessary to require a specific board action or can we instead focus on the goal and leave the means to the board; (iii) Are the board responsibilities prescribed consistent with the board's oversight and policy role; and (iv) Are the board responsibilities clear, up-to-date, and consistent with other regulatory actions? Blass stated that the goal when answering these questions should be to "lean in favor of the answer that most effectively empowers boards to follow robust lines of inquiry."

In the second part of her speech, Blass discussed the broader work of the Division and how such work relates to fund boards. She stated that the Division focuses its work around three principles: (i) improving the retail investor experience; (ii) modernizing its regulatory framework and engagement; and (iii) leveraging its resources efficiently. She discussed the application of these principles as they relate to the SEC's focus on "Main Street" investors. For example, Blass discussed the Investor Experience Initiative, through which the SEC has requested feedback from Main Street investors and others about how to improve their experience with regard to making and understanding fund investments. Additionally, she discussed the proposed exchange-trade fund ("**ETF**") rule designed to "create a consistent, transparent, and efficient regulatory framework for the types of [ETFs] that routinely receive exemptions today," adding that in crafting the proposal, the staff took into consideration the "fiduciary duties of, and regulatory requirements already placed on, fund boards."

- **See a transcript of the speech**

Director of Division of Investment Management Speaks at the ICI Securities Law Developments Conference

On October 25, 2108, Dalia Blass, Director of the Division of Investment Management (the "**Division**") of the SEC, gave the keynote address to the ICI Securities Law Developments Conference in Washington, D.C.

Blass stated that she would focus her discussion on three topics: (i) fund disclosure; (ii) fund use of derivatives; and (iii) staff guidance. She noted that the Division follows a "pretty simple set of principles" when determining how to focus its efforts, adding that the Division wants to improve the investor experience, needs to modernize areas of the regulatory framework and seeks to leverage its resources efficiently. She also noted the strong belief held by the Division that "outcomes improve with understanding," stating that engagement with "investors, with Commissioners, with lawmakers, with industry participants, with investor advocates and with anyone else who would like to share their views and experiences," is the starting point to the Division's approach to each project it undertakes. Blass next turned to improving the investor experience through improving fund disclosure.

Improving the Retail Investor Experience: Fund Disclosure

Blass discussed the initiatives of the Division to improve the investment experience for "Main Street" investors by evaluating the quality and usefulness of information investors receive about funds and advisers. She noted the outreach that the Division has engaged in with investors, including at investor roundtables and through the use of "feedback fliers," which allow investors to submit comments "without needing to review the entire rulemaking proposal or write a letter." She further discussed the use of new technology by asset managers and the potential ability of the Division to use similar technology, as well as the potential need for changes to rules or forms to help "unlock…opportunities for investors." Additionally, she asked, "How do we write the rules of the future so you can provide the disclosure of the future?"

Blass then discussed the recent SEC request for comment in June, which sought feedback on "improving the content, design and delivery of fund disclosure." She added that the Division hopes to hear from a diverse group of commenters, "including those who do not often comment on our rulemakings, like literacy and design experts." Blass added that the SEC "adopted rule 30e-3, issued a request for comment on the framework for fees that intermediaries charge to deliver disclosure documents and proposed a short-form summary to explain the terms of an investor's relationship with a broker-dealer or investment adviser." For a further discussion of Rule 30e-3 under the Investment Company Act of 1940, as amended (the "**Investment Company Act**"), please see the **June 28, 2018 Investment Management Regulatory Update**. Blass also mentioned a potential recommendation to propose a summary prospectus for variable insurance products.

In addition to exploring the SEC's initiatives, Blass emphasized that "asset managers, their counsels, data aggregators and other service providers play a central role in the investor experience," and she encouraged them to consider what steps they can take to improve such experience.

Blass spoke about the importance of a fund's prospectus and summary prospectus to tell a clear story and include a reliable roadmap of the fund's strategies and key risks. Blass pointed to the following examples of practices that do not promote such a roadmap: (i) alphabetized risk factors that ultimately "make[ ] investors work hard to identify what the fund already knows and should tell them"; (ii) generic risk disclosure that has not been tailored to a particular fund; and (iii) disclosure that does not match what the fund is actually doing and does not distinguish what is possible for the fund to do versus what it is actually doing (e.g., "go anywhere funds" that may invest in several asset classes or types of securities, but actually only invest in one or a few of such classes or securities yet provide more disclosure around the asset classes or securities in which they do not invest, or do not primarily invest).

Blass pointed to several examples of fund disclosure practices that concern her, including: (i) mutual fund summary prospectuses that are much longer than the brief documents the SEC intended; (ii) individual sentences that contain over 70 words; (iii) explanations of tracking error with more than 1,000 words; (iv) "summary" risk disclosure that is identical to the full-scale risk disclosure in the statutory prospectus; and (v) excessive legal and regulatory jargon. Blass encouraged those making disclosure not to wait for rulemaking and to work with the staff to improve the investor experience. Blass cited concerns of asset managers, boards and practitioners regarding legal liability stemming from insufficient disclosure. Blass addressed this by stating that "[t]he primary purpose of the disclosure requirements…is to provide investors with information to make an informed investment decision. Informing investors through clear, accessible writing and providing disclosure that meets the legal standard are not mutually exclusive goals." Blass encouraged these parties to "think about how layered disclosure can help achieve both these goals by allowing funds to provide a roadmap and additional detail."

Blass encouraged policy-level engagement from interested parties on the SEC's rulemaking agenda, particularly with respect to disclosure, but also including fund-specific questions. Blass added that the Division is trying to add greater transparency to its review process (e.g., relaunching the Division's disclosure website and posting several "Accounting and Disclosure Information" notes). The Division, according to Blass, plans to continue to add information that may be helpful to filers and investors.

Derivatives Rulemaking

Blass next discussed modernizing the current guidance with respect to funds and derivatives. She stated that the Division is working toward a recommendation for a re-proposal, noting that the SEC "recently started a conversion in 2015, but many commenters were concerned about parts of that proposal." Blass shared some of the questions with which the Division is grappling, including "[H]ow should [the Division] think about leverage risk in a dynamic market?" She added that while the Investment Company Act limits a fund's ability to incur leverage through senior securities, products and practices develop continuously, and the use of derivatives across funds varies widely. Blass questioned how the Division can "honor the policy of the Investment Company Act while providing sufficient flexibility." She continued questioning whether there is "an approach that provides meaningful boundaries for the use of derivatives while recognizing the diversity of funds and the benefits derivatives can provide when used responsibly[.]"

Blass also questioned the role that risk management should play, asking, "Should a rule specifically recognize that risk management and related risk metrics are or should be conceived of holistically across interrelated areas, like liquidity and leverage? What role should asset segregation play? Asset segregation has been a feature of the landscape since 1979, but practices have varied significantly. What are funds doing today? Are additional, risk-based buffers common? What role should these practices play in a rule."

Blass encouraged sponsors, scholars, risk managers and others to share their thoughts.

Staff Guidance

Blass concluded by addressing questions regarding staff guidance. Blass referenced Chairman Clayton's recent statement that all staff statements "are nonbinding on the [SEC] and create no enforceable legal rights or obligations of the [SEC] or other parties." Additionally, she discussed the two staff letters issued in 2004 to proxy advisory firms that have been withdrawn by the Division. For a further discussion of the withdrawal of the two no-action letters, please see the **September 28, 2018 Investment Management Regulatory Update**. Blass emphasized that Chairman Clayton's statement "reaffirmed what we all knew already": that statements of the staff do not have the force of law and are not statements of the SEC. She added that the SEC will continue to review and assess prior staff statements (including letters and frequent comments).

- **See a transcript of the remarks**

OCIE Issues Risk Alert Regarding Investment Advisers and Cash Solicitation Rule Compliance Issues

On October 31, 2018, the Office of Compliance Inspections and Examinations ("**OCIE**") of the SEC issued a risk alert (the "**Risk Alert**") to provide investment advisers, investors and other market participants with information regarding the most common deficiencies cited in recent examinations with respect to compliance with Rule 206(4)-3 (the "**Cash Solicitation Rule**") under the Investment Advisers Act of 1940 (the "**Advisers Act**").

According to the Risk Alert, under the Cash Solicitation Rule, investment advisers required to be registered under the Advisers Act are prohibited from paying a cash fee to any person who solicits clients for the adviser unless the arrangement complies with certain specified conditions. The Risk Alert states that these conditions require, among other things, that the cash fee be paid pursuant to a written agreement to which the adviser is a party (the "**Solicitation Agreement**"), and that the solicitor not be a person subject to certain disqualifications specified in the Cash Solicitation Rule.

According to the Risk Alert, the Cash Solicitation Rule imposes additional requirements if the solicitor is not a partner, officer, director or employee of the adviser or an entity that controls, is controlled by or is under common control with the adviser (a "**Third-Party Solicitor**"). In the Risk Alert, the OCIE noted the following additional requirements that apply when an adviser uses a Third-Party Solicitor:

- The Solicitation Agreement must contain specified provisions, including a description of the solicitation activities and compensation to be received;
- The Solicitation Agreement must require that, at the time of any solicitation activities, the solicitor provide the prospective client with a copy of (a) the adviser's Form ADV brochure and (b) a separate, written disclosure document containing required information that highlights the solicitor's financial interest in the client's choice of an adviser (the "**Solicitor Disclosure Document**");
- The adviser must receive from the client, either before or at the time of entering into any written or oral agreement with the client, a signed and dated acknowledgement that the client received the adviser brochure and the Solicitor Disclosure Document (the "**Client Acknowledgement**"); and

- The adviser must make a bona fide effort to determine whether the solicitor has complied with the Solicitation Agreement and must have a reasonable basis for believing that the solicitor has complied.

In the Risk Alert, OCIE identified some of the most common issues cited in examinations related to an adviser's compliance obligations under the Cash Solicitation Rule:

- Solicitor Disclosure Documents: The OCIE staff observed advisers whose Third-Party Solicitors either failed to provide Solicitor Disclosure Documents to prospective clients or provided Solicitor Disclosure Documents that did not contain all the information required under the Cash Solicitation Rule. For example, OCIE staff observed Solicitor Disclosure Documents that did not: (i) disclose the nature of the relationship between the solicitor and the adviser; (ii) contain the terms of the compensation arrangement; (iii) specify the actual compensation terms under the Solicitation Agreement and instead used "vague or hypothetical terms" to describe the solicitor's compensation; or (iv) specify the additional cost the solicited client will be charged in addition to an advisory fee.
- Client Acknowledgements: The OCIE staff observed advisers that did not timely receive a Client Acknowledgement. The OCIE staff also observed advisers that received acknowledgements from clients that were undated or dated after the clients had entered into investment advisory contracts.
- Solicitation Agreements: The OCIE staff observed advisers that paid cash fees to a solicitor without a Solicitation Agreement in effect or pursuant to an agreement that did not contain certain required provisions. For example, the OCIE staff observed Solicitation Agreements with Third-Party Solicitors that did not: (i) contain an undertaking by the solicitor to perform its duties under the agreement in a manner consistent with the adviser's instructions; (ii) describe the solicitor's activities and compensation; or (iii) require solicitors to provide clients and prospective clients with a current copy of the adviser brochure and the Solicitor Disclosure Document.
- Bona Fide Efforts to Ascertain Solicitor Compliance: The OCIE staff observed advisers that did not make a bona fide effort to determine whether Third-Party Solicitors complied with Solicitation Agreements and appeared not to have a reasonable basis for believing that the Third-Party Solicitors complied. For example, OCIE staff observed advisers that were unable to describe any efforts taken by the adviser to confirm compliance with the Solicitation Agreements.

The Risk Alert also indicated that deficiencies under the Cash Solicitation Rule may implicate other provisions of the Advisers Act, such as an adviser's fiduciary duty under Sections 206(1) and 206(2) of the Advisers Act. For example, OCIE staff observed advisers that recommended service providers to clients in exchange for client referrals without full and fair disclosure of the conflicts of interest.

The OCIE staff finally noted that the examinations which produced the information discussed above resulted in "a range of actions," and certain investment advisers amended their disclosure documents and Solicitation Agreements, revised their related compliance policies and procedures or amended their related practices. In publishing the Risk Alert, OCIE "encourages advisers to reflect upon their practices, policies and procedures in these areas and to promote improvements in [their] compliance programs."

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

OCIE Issues Risk Alert Regarding Risk-Based Examination Initiatives

On November 8, 2018, OCIE issued a risk alert (the "**Risk Alert**") on the topic of risk-based examination initiatives focused on mutual funds and ETFs (collectively, "**Funds**"). OCIE staff will be conducting these Fund examinations in order to "assess industry practices and regulatory compliance in certain areas that may have an impact on retail investors." According to the Risk Alert, these examinations will generally focus on: (i) policies and procedures of the Funds and/or their advisers, including Fund board oversight of Fund compliance programs, in order to validate that they are designed to address risks and conflicts; (ii) disclosures to investors by Funds in their prospectuses and other filings and shareholder communications and to Fund boards by advisers, regarding risks and conflicts; and (iii) certain deliberative processes of Funds, their advisers and their boards exercising oversight, specifically regarding their review of practices and controls related to risks and conflicts, which include disclosures, portfolio management compliance and Fund governance.

In the Risk Alert, the OCIE staff identified six areas that these examinations will focus on and relevant risks associated with each topic:

- Index Funds that track custom-built indexes. According to the Risk Alert, the OCIE staff will focus on unique risks associated with custom-built indexes, such as: (i) the "selection and weighting" of bespoke index components; (ii) ongoing index administration; (iii) management of the Funds; and (iv) related performance advertising. The OCIE staff will also review: (i) how these portfolios are managed compared to their related disclosures; (ii) the nature of services provided by index providers and the adequacy of related disclosures made to Fund boards; (iii) conflicts of interest between index providers and advisers and how they are addressed; and (iv) the effectiveness and oversight of compliance programs.
- Smaller and/or thinly traded ETFs. According to the Risk Alert, the OCIE examinations will assess whether: (i) associated investment risks are "adequately disclosed to investors"; (ii) board oversight addresses the ETF's "ability to continue as an ongoing concern"; (iii) tracking errors are effectively monitored; (iv) portfolios are appropriately liquidated for distribution to shareholders upon liquidation; and (v) delisting and liquidation proceedings have received the requisite board approvals and oversight.
- Mutual funds with higher allocations to certain securitized assets. According to the Risk Alert, during examinations of these mutual funds, the OCIE staff will focus on: (i) policies and procedures related to portfolio management activities; (ii) "risk identification, monitoring and mitigation practices"; (iii) policies and procedures related to valuation and pricing; (iv) governance and board oversight practices; and (v) disclosure to investors, including disclosure related to investment risks.
- Funds with aberrational underperformance relative to their peer groups. The OCIE staff "will seek to understand the factors for the mutual funds'" underperformance relative to their peer groups. According to the Risk Alert, the OCIE staff will also review the effectiveness of these Funds' compliance programs and management processes, including whether these Funds or advisers: (i) invest in a manner consistent with such Funds' objectives and/or strategies (as disclosed in their prospectuses and other filings); (ii) use advertising and marketing materials that are complete and accurate; (iii) allocate investment opportunities consistently with the advisers' fiduciary duty; and (iv) adhere to applicable requirements with respect to borrowing or leverage.
- Advisers relatively new to managing registered investment companies. According to the Risk Alert, these examinations will focus on: (i) Fund governance to "ensure that boards are provided with sufficient information to perform their duties"; (ii) the effectiveness of compliance programs; and (iii) marketing and distribution efforts related to the Funds.
- Advisers who provide advice to both mutual funds and private funds that have similar strategies and/or are managed by the same portfolio managers. According to the Risk Alert, these Funds will be evaluated for: (i) policies and procedures addressing potential conflicts of interest and "other risks associated with side-by-side management"; (ii) controls related to

brokerage, best execution and trade allocation practices; (iii) allocation practices for "various fees and expenses"; and (iv) appropriate disclosures to Funds' boards and investors.

The Risk Alert indicated that the OCIE staff may also select topics, in addition to the above, based on their findings during the course of these examinations. The OCIE staff also encourages registrants to "reflect upon their own practices, policies, and procedures, as applicable, and to consider improvements in their supervisory, oversight, and compliance programs, as may be appropriate."

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

Litigation

SEC Halts ICO, Suspends Nevada Corporation's Securities Trading for False Claims of SEC Approval

In October, the SEC took enforcement action against several entities that allegedly sought to sell cryptocurrency-related securities on the basis of misrepresentations that the SEC had approved of or otherwise authorized the offerings.

On October 3, 2018, the SEC filed a complaint (the "**Blockvest Complaint**") in the U.S. District Court for the Southern District of California, seeking to enjoin an initial coin offering by Blockvest LLC ("**Blockvest**") and its founder and principal, Reginald Buddy Ringgold, III, aka Rasool Abdul Rahim El ("**Ringgold**"), and to freeze the assets of Blockvest and Ringgold.

According to the Blockvest Complaint, Blockvest and Ringgold falsely claimed that their ICO has been "registered" and "approved" by the SEC, falsely represented that they had created the first licensed and regulated tokenized cryptocurrency exchange and index fund, and used the SEC's seal to promote their offering. The Blockvest Complaint states that Ringgold and Blockvest made a number of false representations regarding regulatory approval of the ICO, including that the ICO was "Reg A+ . . . approved," that Blockvest or its officers were registered with the CFTC, NFA, or FINRA and that Blockvest had "partnered" with and was audited by Deloitte. To further create an impression of credibility, Ringgold allegedly created a website for a fictitious regulatory agency, the "Blockchain Exchange Commission," or "BEC" and indicated the Blockvest ICO was "approved" by the spurious "BEC."

The SEC alleged that Blockvest and Ringgold's actions violated Section 17(a) of the Securities Act of 1933 (the "**Securities Act**") and Section 10(b) of the Securities Exchange Act of 1934 (the "**Exchange Act**") and Rule 10b-5 thereunder, as well as the securities offering registration provisions of Section 5 of the Securities Act. On October 11, 2018, Judge Gonzalo P. Curiel of the U.S. District Court for the Southern District of California issued an order freezing the assets of Blockvest and Ringgold, and prohibiting further violations of the antifraud and registration provisions of the Securities Act and Exchange Act.

On October 19, 2018, the SEC issued an order (the "**ARG Order**") suspending trading in the securities of American Retail Group, Inc. ("**ARG**"). In May 2018, ARG acquired a company that ARG described in SEC filings as "engaged in Russia in the development and commercialization of a multi-functional online international digital asset management, investment and trading platform." In August 2018, ARG announced that it had entered into a partnership with "Prime Trust," which it described as a "providing SEC qualified custodian and escrow services, both for fiat money transactions and bitcoin, Ethereum and ERC20 tokens," and stated that "all transactions provided by Prime Trust are under SEC Regulations." The SEC concluded that these statements raised "concerns about the accuracy and adequacy of information in the marketplace" about ARG, and accordingly suspended trading in ARG from October 22, 2018, through November 2, 2018.

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

- See a copy of the ARG Order of Suspension of Trading

SEC Sues Controlling Member of Private Equity and Investment Adviser Firms for Alleged Sales of "Essentially Worthless" Asset-Backed Securities, Enters into Consent Judgment

On October 16, 2018, the SEC filed a complaint (the "**Burns Complaint**") against Alexander C. Burns ("**Burns**") and Andrew B. Scherr ("**Scherr**," and together with Burns, the "**Defendants**") in the U.S. District Court for the Southern District of New York, alleging that the Defendants gained control over the investment funds of several insurance companies and reinsurance trusts, and caused them to transfer over $300 million to entities the Defendants controlled in exchange for "essentially worthless" securities.

According to the Burns Complaint, the SEC alleged that between March 2013 and February 2014, the Defendants owned and controlled two investment entities: a private equity firm, Southport Lane Management, LLC ("**SLM**"), and its wholly owned subsidiary and a registered investment adviser, Southport Lane Advisors, LLC ("**SLA**"). At the direction of the Defendants, SLM is alleged to have fraudulently acquired majority interests in five insurance companies and acquired control of the funds in seven separate reinsurance trusts. The Burns Complaint notes that SLM allegedly obtained these interests, at least in part, in exchange for "essentially worthless or grossly overvalued" securities created by the Defendants.

According to the Burns Complaints, once SLM acquired interests in the insurance companies and reinsurance trusts, it allegedly caused those entities to enter into investment agreements with SLA, allowing SLA to make investment decisions for the insurance company and reinsurance trust capital reserve assets. Subsequently, the Defendants allegedly acquired assets that were either worthless or overvalued, securitized them, and caused the capital reserve assets of SLA's clients to be invested in these securities. In short, SLM and its affiliates allegedly created and owned the securities, assigned inflated values to the securities, then sold these securities to SLA's clients, without disclosing the nature of the securities or that the transactions involved parties related to SLA and SLM. In one example, Scherr allegedly caused an affiliated company to purchase an interest in a painting for $15 million. The company then allegedly sold this interest to SLM for $40 million. Burns, through SLM affiliates, next allegedly securitized the interest and valued it at $128 million. Subsequently, SLA allegedly invested its clients' funds in these securities, resulting in a fraudulently obtained windfall to the Defendants and their controlled entities of approximately $175 million.

As a result of this conduct, the SEC alleges that Burns violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 206(1), 206(2), and 206(3) of the Advisers Act. The SEC further alleged that Burns aided and abetted violations of Section 17(a)(2) of the Securities Act, Section 10b-5 of the Exchange Act and Rule 10b-5 thereunder, and Sections 206(1), 206(2), and 206(3) of the Advisers Act. The SEC alleged that Scherr aided and abetted violations of Sections 206(1), 206(2), and 206(3) of the Advisers Act. On October 16, 2018, Burns, without admitting or denying the allegations, consented to a judgment permanently enjoining him from violating the antifraud provisions of the securities laws, and ordering him to pay disgorgement, prejudgment interest, and civil monetary penalties to be determined at a later date.

- See a copy of the Burns Complaint

Former Executive Sentenced to 18 Months in Prison for Defrauding Investors

On October 16, 2018, former executive vice president of State Street Corporation (**"State Street"**) Ross McLellan ("**McLellan**") was sentenced to 18 months in prison following his conviction on June 26, 2018 on several counts of securities fraud, wire fraud, and conspiracy to commit securities fraud and wire fraud.

According to evidence presented at trial, from February 2010 until September 2011, McLellan and two of his subordinate employees defrauded at least six of State Street's Transition Management customers by charging "hidden and unauthorized mark-ups" on trading in U.S. and European securities. Under the supervision of McLellan, employees would misrepresent charges in connection with certain "transition engagements," and disseminate these misrepresentations to clients through false trading statements, pre-trade estimates and post-trade reporting.

The evidence at trial further revealed that McLellan took various steps to hide the commissions from clients and other State Street employees. For example, McLellan instructed his employees to delete any reference to a mark-up after the commission was added onto a trade. McLellan and his employees would also use "fixed income trades" as the vehicle for hiding the added commissions, and would deliberately select specific transitions on which to carry out the scheme. Usually, the transitions that were selected were "larger than others" because they were "easier to hide the mark-ups." In addition to concealing the mark-ups, the evidence demonstrated that McLellan aided and abetted his subordinate employees by directing them to make materially false and misleading statements when ultimately confronted about the hidden mark-ups by one of the bank's customers, characterizing the mark-ups as being a "fat finger error" and "inadvertent commissions."

Based on the conduct described above, the jury convicted McLellan of one count of conspiracy to commit securities fraud and wire fraud, two counts of securities fraud and two counts of wire fraud. Judge Leo T. Sorokin of the U.S. District Court for the District of Massachusetts sentenced McLellan to 18 months in prison, followed by two years of supervised release. Similarly, the SEC has indicated that collectively, the customers were overcharged approximately $20 million. The SEC filed a complaint against McLellan on May 13, 2016 in federal court in Boston (the "**McLellan Complaint**"), charging McLellan with violating the antifraud provisions of Section 17(a) of the Securities Act, and aiding and abetting violations of the antifraud provisions of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder by others at State Street. The SEC's parallel civil action against McLellan is ongoing.

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

SEC Settles with Former Investment Adviser and Former CEO for Due Diligence Failures and Inadequately Resourced Compliance Program

On November 6, 2018, the SEC issued an order (the "**Pennant Order**") instituting and settling cease-and-desist proceedings against Pennant Management, Inc. ("**Pennant**"), a Wisconsin-based corporation formerly registered as an investment adviser. According to the Pennant Order, Pennant failed to perform adequate due diligence on certain repurchase agreement investments, failed to provide adequate resources to its compliance program and failed to reasonably design and implement certain related policies and procedures.

According to the Pennant Order, the SEC alleged that, between May 2013 and September 2014, Pennant's most significant business was advising its clients on the purchase of "pro rata shares in nine facilities containing repurchase agreements for portions of loans guaranteed by various government entities, including the U.S. Department of Agriculture." These loans were originated by, among others, a third-party lender, First Farmers Financial ("**First Farmers**"). Pennant's Form ADV disclosed that Pennant would perform "initial and ongoing due diligence and monitoring" of First Farmers and other repo counterparty sellers. According to the SEC, while Pennant employees used a checklist in conducting initial due diligence and sought the most recent audited financial statements and tax returns from First Farmers and other originators, Pennant allegedly did not have relevant written policies and procedures, and the informal general practices used were deficient due to a lack of any guidance as to what information within the documents noted in the checklist was important in conducting due diligence. Pennant also allegedly failed to disclose to clients negative information or "red flags" uncovered during its due diligence. For example, although First Farmers failed to provide certain financial statements and information, Pennant's investment committee nonetheless allegedly raised the limits for the First Farmers repo facility. Pennant also allegedly conducted additional due diligence, including the hiring of a private investigation firm to perform a background check, which uncovered red flags, including a prior legal action against the Chief Executive Officer of First Framers, as well as fraud involving the loans underlying the investments that Pennant was advising its clients to make. The SEC alleged that Pennant did not disclose these findings to its clients, who made additional investments backed by First Farmers loans during this time.

The SEC also alleged that Pennant failed to provide adequate resources to its compliance program, which resulted in numerous compliance failures. According to the Pennant Order, Pennant appointed a portfolio manager with no prior compliance experience as "interim" chief compliance officer (the "**CCO**"). After "educating himself about the compliance requirements of a registered investment adviser" and reviewing Pennant's policies and procedures, the CCO concluded that Pennant's compliance program was deficient, advised Pennant's CEO of his concerns, and requested additional resources including outside compliance advisors. Further, according to the Pennant Order, the CCO also allegedly agreed to serve as permanent CCO only if given access to outside counsel, if Pennant would engage compliance consultants and if he would be relieved of his portfolio manager duties. Although Pennant agreed to these conditions, it failed to add compliance resources and allegedly cut $80,000 from Pennant's budget earmarked for additional compliance staff. According to the Pennant Order, Pennant's CCO allegedly informed Pennant's board that the lack of compliance resources created a risk of a "compliance issue [going] unnoticed" and "urged" the board to add compliance resources over several years as part of his annual compliance review. According to the Pennant Order, the SEC concluded that the "denial of resources" to the compliance program resulted in compliance failures, including failures to follow investment allocation, due diligence, and gift policies. Pennant later hired additional compliance staff and retained an outside compliance consultant to assist with its compliance requirements.

Based on the conduct described above, the SEC found that Pennant violated Section 204 of the Advisers Act and Rule 204-2(a)(3) thereunder, which require the maintenance of true and accurate books and records; Section 206(2) of the Advisers Act, which prohibits an investment adviser from engaging directly or indirectly in any transaction that operates as a fraud upon a client; Section 206(4) and Rule 206(4)-7 thereunder, which require the adoption and implementation of written compliance policies and procedures designed to prevent violation of the Advisers Act and the rules thereunder; and Section 207 of the Advisers Act, which prohibits the making of untrue statements in applications or reports filed with the SEC. Pennant consented to the entry of the Pennant Order and, without admitting or denying the findings, agreed to cease and desist from future violations of the securities laws discussed above. Pennant further agreed to be censured and to pay a civil money penalty of $400,000.

Additionally, the SEC issued a separate order (the "**Elste Order**") instituting and settling proceedings against Pennant's former CEO Mark A. Elste, finding that Elste had aided and abetted Pennant's compliance failures. The SEC found that Elste had aided, abetted, and caused Pennant's violations of Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder. Elste agreed to be censured and to pay a civil money penalty of $45,000.

The Pennant Order serves as a clear reminder of the importance of a well-resourced compliance program, and that compliance program failures can easily lead to failures of core investment processes, including counterparty due diligence and investment allocation. Viewed against the backdrop of public concerns that SEC enforcement action may have a "chilling effect" on compliance professionals (as recently articulated **in a speech by Commissioner Pierce**, for example), contrasting the Elste Order with the SEC's decision not to identify the CCO by name suggests that the SEC intends to send adviser management a message: A CCO's responsibilities in a similar situation are to educate oneself on compliance requirements, to alert management of potential failures, to demand the resources needed for an adequate compliance function, and to escalate matters to a board of directors or other supervisory body if action is not taken. A CEO's responsibility, by contrast, is to take action when informed of compliance failures and a lack of resources, at the risk of later being held responsible for aiding and abetting violations arising out of such lack of resources.

- **See a copy of the Pennant Order**
- **See a copy of the Elste Order**

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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