Funds and Investment Management

Regulatory Update and Recent SEC Enforcement Actions

REGULATORY UPDATE

Ten Investment Advisory Firms Subject to Steep Penalties after Violating Pay-to-Play Rules

In January 2017, 10 investment advisory firms agreed to settle with the U.S. Securities and Exchange Commission (“SEC”) after an investigation found the firms in violation of Section 206(4) of the Investment Advisers Act of 1940, and specifically Rule 206(4)-5, the “SEC pay-to-play rule,” which prohibits investment advisory firms from providing compensated services to a government entity or client for two years after making a political contribution to officials of or candidates for that government entity or client. The SEC found that the firms violated the pay-to-play rule by accepting fees from city or state pension funds after making political contributions to elected officials and candidates who potentially had influence over the pension funds at issue. The following firms were censured and must pay penalties ranging from $35,000 to $75,000: Adams Capital Management; Aisling Capital; Alta Communications; Commonwealth Venture Management Corporation; Cypress Advisors; FFL Partners; Lime Rock Management; NGN Capital; Pershing Square Capital Management; and The Banc Funds Company. In addition to these 10 firms, Brown Advisory LLC recently applied for an exemption under the rule after one of its associates inadvertently contributed $1,000 to Maryland’s then-governor elect Larry Hogan’s campaign.

SEC to Investigate Yahoo! Data Breach

On January 23, 2017, the SEC launched an investigation into whether Yahoo!’s disclosures regarding its recent cyberattack and data breach adequately complied with civil securities laws. Under SEC disclosure guidelines, companies must disclose any risks associated with cybersecurity as soon as the company determines that these risks would have an effect on investors. In September 2016, Yahoo! disclosed a data breach from 2014 whereby over 500 million users were affected, and in mid-December 2016 Yahoo! stated that it had discovered another data breach that occurred in August 2013 that exposed private information of at least one billion users. While the SEC has yet to bring a case against a company for failing to disclose cybersecurity risks because it is difficult to pinpoint what constitutes a “material” issue, both Yahoo! investors’ and potential merger candidate Verizon Communications’ shares declined as a result of the data breach, instigating the investigation.

Citigroup Fined for Excessive Billing of Investment Advisory Clients

On January 26, 2017, the SEC announced that Citigroup Global Markets consented to a cease-and-desist order, to be censured, and to pay $3.2 million in disgorgement, plus $800,000 in interest and $14.3 million in penalties to settle charges that it overcharged advisory clients. According to the SEC’s order, over 60,000 of Citigroup’s advisory clients were overbilled roughly $18 million in fees because Citigroup could not accurately confirm billing rates
within its computer systems compared with fee rates detailed in client contracts, billing histories, and other billing-related documents because it lost client contracts. Additionally, Citigroup improperly collected fees while client accounts were suspended. Furthermore, Citigroup was unable to verify whether fee rates remained the same as when the accounts were opened and negotiated with clients.

Advisory clients have every expectation that the fees charged by their financial adviser reflect the negotiated rate. Citigroup failed to take the necessary precautions to ensure clients were billed in a manner consistent with their advisory agreements.

— Andrew M. Calamari
Director of the SEC’s
New York Regional Office

Division of Investment Management to Permit Open-End Funds to Invest in Closed-End Funds

On January 25, 2017, the SEC’s Division of Investment Management granted Dechert LLP’s request for exemptive relief and concluded that a registered open-end investment company or registered unit investment trust can rely on Rule 12(d)(1)-(2) of the Investment Company Act (the “40 Act”) in order to invest in a closed-end fund irrespective of whether the two investment companies hold themselves out as related entities. Under Section 12(d)(1)(A) a fund is prohibited from acquiring securities issued by another investment company if, immediately after the acquisition, the fund (1) owns more than three percent of the outstanding voting stock of the acquired fund; (2) has more than five percent of its total assets invested in the acquired fund; or (3) has more than 10 percent of its total assets invested in the acquired fund and all other investment companies. Additionally, under Section 12(d)(1)(G) open-end funds are granted an exemption and are permitted to invest in other open-end funds so long as the two funds are part of the same “group” of investment companies. To fall under the same group of investment companies, two or more funds must hold themselves out as related companies for investment purposes and investor services. Furthermore, Rule 12(d)(1)(2) permits open-end funds relying on the 12(d)(1)(G) exemption to invest in securities issued by registered investment companies “other than securities issued by another registered investment company that is in the same group of investment companies.” The Rules’ language leave open the possibility that closed-end funds considered as part of an investing fund’s “group of investment companies” may not qualify as “permitted investments.” In other words, prior to the SEC’s clarification, an open-end fund arguably could have been prohibited from investing in closed-end funds although deemed to be within the same group. Nonetheless, the SEC clarified this concern by stating that a “group of investment companies” refers, for the purposes of Rule 12(d)(1)-(2), only to open-end funds that hold themselves out as related companies. Therefore, the SEC would not oppose an open-end fund relying on the 12(d)(1)(G) exemption from investing in a closed-end fund no matter the relationship between the two funds so long as the funds adhere to the limitations set forth in the Rule.

SEC’s Division of Investment Management Issues Interpretive Letter on Section 22(d) of the Investment Company Act

On February 2, 2017, the Division of Investment Management offered its interpretation of Section 22(d) as it relates to the distribution of fund shares. Under Section 22(d), funds are prohibited from selling securities except at “a current public offering price described in the prospectus” to any person other than to or through a principal underwriter for distribution. Additionally, “if such class of security is being currently offered to the public by or through an underwriter, no principal underwriter of such security and no dealer shall sell any such security to any person except a dealer, a principal underwriter, or the issuer, except at a current public offering price described in the prospectus.” According to the Division of Investment Management Staff, the restrictions laid out in Section 22(d) do not apply to brokers when the broker acts as an agent on behalf of its customers and then charges its customers commission for effecting transactions in a class of fund shares without any front-end load, deferred sales charge, or other asset-based fee for sales or distribution. This is referred to in the letter as “Clean Shares.” Additionally, the Staff reiterated that Section 22(d) does not prevent principal underwriters of Clean Shares from entering into selling agreements with brokers under the circumstances described in the interpretive letter. Essentially, the Staff concluded that brokers are implicitly allowed to receive non-distribution-related accounting fees.

Implementation of Department of Labor’s (“DOL”) Fiduciary Rule Delayed by 60 Days

On April 4, 2017, the U.S. Justice Department announced in the Federal Register that the Office of Management and Budget completed its review of the DOL’s fiduciary rule and determined
that implementation of the rule would be moved from April 10 to June 9, 2017.

SEC Office of Compliance Inspections and Examinations (“OCIE”) Releases Risk Alert Highlighting Areas of Risk for Investment Advisers

On February 7, 2017, OCIE issued a Risk Alert focusing on five critical areas of risk for investment advisers. Investment advisers should prepare for upcoming exams by concentrating on the following areas:

- **Compliance Rule**: advisers are prohibited from offering investment advice to clients unless the adviser: (a) adopts and implements compliance procedures in writing; (b) annually reviews these procedures for effectiveness; and (c) designates a Chief Compliance Officer (“CCO”) to administer the procedures and related policies.

- **Regulatory Filings**: advisers must file the following regulatory filings: Form ADV (annually); Form PF (advisers to one or more private funds with assets of over $500 million); and Form D (no later than 15 days after the first sale of securities in the offering of a private fund).

- **Custody Rule**: advisers in custody of client cash or securities or those that maintain the authority to obtain possession of them must comply with the rule, specifically with respect to the protection of client assets.

- **Code of Ethics**: advisers must have a “Code of Ethics,” which must: (a) establish standard business conduct for supervised persons; (b) require access persons to periodically report personal securities transactions and holdings to a designated person; and (c) require that access persons obtain the adviser’s approval before investing in an IPO or private placement.

- **Books and Records**: advisers must maintain and keep specified books and records, including common accounting and other related business records.

**U.S. District Judge Grants DOL’s Motion for Summary Judgment over Challenge to Fiduciary Rule**

On February 8, 2017, U.S. District Judge Barbara M.G. Lynn granted the DOL’s motion for summary judgment and denied cross-motions from the U.S. Chamber of Commerce, the Securities Industry and Financial Markets Association (“SIFMA”), and other industry groups, upholding the DOL’s new fiduciary rule for retirement advisers. Judge Lynn found that the DOL did not exceed its authority and adequately weighed the costs and benefits in devising its new fiduciary rule requiring retirement account advisers to act in their clients’ best interests. The court’s decision was filed hours after the DOL requested a stay of the suit, arguing that it would not be judicious to make a ruling while the DOL reviews the rule as the agency considered to delay the implementation date per a directive ordered by President Trump. On March 20, 2017, Judge Lynn denied a request for an emergency injunction by the U.S. Chamber of Commerce, the SIFMA, and other industry groups because these groups did not prove that they would suffer irreparable harm without a block on the rule largely because the DOL had already stated that it intended to delay the implementation and enforcement of the rule. The implementation date of the rule is currently set for June 9, 2017.

**Interim Head of SEC Curbs Enforcement Staff’s Subpoena Power**

On February 15, 2017, Michael Piwowar, acting head of the SEC, revoked the power to issue subpoenas from roughly 20 enforcement division personnel and instead granted it solely to the enforcement division director. According to SEC insiders, Piwowar sought to bring consistency to the enforcement and investigation process by limiting abundant SEC oversight. This action directly opposes what the Obama administration had established over the past eight years. In 2009, SEC Chairman Mary Schapiro increased the enforcement division’s investigative authority and witnessed the amount of formal orders of investigation more than double, from 233 to 496. Under previous SEC Chairman Mary Jo White, the SEC conducted a record number of investigations—681 in 2016 alone. Although Piwowar maintains the authority to determine how many enforcement staff officials can issue subpoenas, he is prohibited from revoking the power of the enforcement director to issue subpoenas on his own.

**Department of Justice (“DOJ”) Issues New Guidance for Corporate Compliance Programs**

On February 8, 2017, the Fraud Section of the U.S. DOJ released a list of factors (the “Filip Factors”) it utilizes to evaluate corporate compliance programs. The DOJ released this guidance to the public in an effort to provide more transparency with respect to what federal prosecutors look for in such reviews. Filip Factors include “the existence and effectiveness of the corporation’s pre-existing compliance program” and the remedial efforts the corporation has taken “to implement an effective corporate compliance program or to improve an existing one.” Specifically,
the DOJ’s new compliance program guidance is split into 11 sections: (1) Analysis and Remediation of Underlying Conduct; (2) Senior and Middle Management; (3) Autonomy and Resources; (4) Policies and Procedures; (5) Risk Assessment; (6) Training and Communications; (7) Confidential Reporting and Investigation; (8) Incentives and Disciplinary Measures; (9) Continuous Improvement, Periodic Testing and Review; (10) Third-Party Management; and (11) Mergers and Acquisitions.

Additionally, DOJ prosecutors revealed some key areas that they suggest corporate compliance programs should consider implementing. Such areas include:

- The “design and accessibility” of policies and procedures and whether they are specifically designed to fit a company’s risk profile, have been executed and conveyed effectively, and have been analyzed to guarantee utility;

- The “operational integration” of policies and procedures (i.e., the sufficiency of payment systems and other checks designed to identify and/or avert misconduct);

- Signs of “autonomy” such as whether compliance officers maintain “direct reporting lines to anyone on the board of directors” and whether “relevant control personnel in the field have reporting lines to headquarters”; and

- Signs of “empowerment” such as cases where “specific transactions or deals...were stopped, modified, or more closely examined as a result of compliance concerns.”


**Division of Investment Management Grants No-Action Relief to Investment Adviser Association (“IAA”) under the Custody Rule**

On February 23, 2017, the SEC’s Division of Investment Management answered a request made by IAA with respect to the “custody rule.” Under Rule 206(4)-2 of the Investment Advisers Act of 1940, investment advisers, in most cases, must maintain client funds and securities with a “qualified custodian.” Qualified custodians under the Rule include the types of financial institutions to which clients and advisers customarily turn for custodial services, including banks, registered broker-dealers, and registered futures commission merchants. In 2009, the SEC amended the custody rule to require investment advisers to undergo an annual surprise examination by an independent public accountant to verify client assets. However, the IAA requested no-action relief and argued that when investment advisers merely follow clients’ instructions to transfer assets, investment advisers are technically not holding client funds, do not have the authority to obtain client funds, and are not able to withdraw client funds for any purpose as intended by the custody rule. The Division of Investment Management Staff disagreed. The Staff concluded that an investment adviser with authority to dispose of client funds or securities for any purpose other than authorized trading is deemed to have access to the client’s assets. According to the Staff, a letter of instruction or similar agreement established by a client with a qualified custodian would create an arrangement whereby the investment adviser has the authority to withdraw client funds or securities kept with a qualified custodian upon the client’s instruction to the custodian. As such, the investment adviser has custody of the assets and is subject to a surprise examination under the custody rule. Ultimately, the Staff agreed not to recommend enforcement action should an investment adviser not obtain a surprise examination when acting upon the aforementioned arrangement so long as certain criteria are met: first, the client must instruct the qualified custodian in writing with the client’s signature, the name of the third party and the address or account number of the custodian to which the transfer is being directed; second, the client must authorize the adviser in writing to direct transfers to the third party on the qualified custodian’s form (or separately) and pursuant to a particular
schedule or periodically; third, the custodian must verify the
client’s instruction by reviewing the client’s signature or through
similar means of verifying the client’s authorization. The custodian
must promptly report the transfer of funds to the client, and then
notify the client in writing to confirm the initial instruction as well
as confirm the instruction on an annual basis. According to the
Staff, starting October 1, 2017, investment advisers should include
client assets that are subject to any arrangements that result in
custody in its response to Item 9 of Form ADV.

SEC to Focus on Corporate Penalties, Aggressive
Enforcement Actions, and Budget Concerns under
Trump Administration

On February 28, 2017, interim SEC Chair Michael Piwowar and
former commissioner Paul Atkins, President Trump’s financial
policy adviser, suggested at the Practicing Law Institute “SEC
Speaks” seminar that the SEC will focus on large corporate
penalties, aggressive rulemaking and enforcement cases, and
the agency’s budget. Piwowar questioned whether substantial
civil monetary penalties hurt investors who have already been
negatively impacted by corporate misconduct. According
to Piwowar, high corporate monetary penalties largely hurt
shareholders who have theoretically already been harmed by
decreasing stock prices as a result of the corporate misconduct.
Piwowar did, however, state that he supports bribery and
corruption fines for Foreign Corrupt Practice Act violations.
Regarding enforcement actions, remarks made during the seminar
suggested that under President Trump the SEC may pull back on
surprise examinations and enforcement actions in general. With
respect to the SEC’s resources, the agency will likely have less
funds to work with under the Trump regime because the House
Committee on Financial Services rejected the SEC’s request for
increased funding for the 2018 fiscal year. In rejecting the SEC’s
proposed budget increase, one concern of the House Committee
on Financial Services was that the SEC has failed to meet statutory
deadlines for various rulemakings and has failed to improve its
time for investment advisers.

Proxy Advisory Firm Convinces Shareholders to Vote
Down Board Proposals

On February 28, 2017, Oakmark Funds (“Oakmark”) shareholders
voted down three proxy proposals asking shareholders to approve
seven current and one new director, to amend certain investment
restrictions, and to amend the declaration of trust. Specifically,
Oakmark proposed to change the ability of shareholders to bring
derivative claims (requiring the fund directors’ approval before
they can bring about a lawsuit against the investment adviser),
requiring shareholders to file lawsuits in Massachusetts (the
commonwealth in which Oakmark is incorporated), and other
various governance policies. However, a report conducted by
proxy advisory firm Institutional Shareholder Services (“ISS”), who
publishes such reports on compelling proxy issues throughout the
industry, successfully convinced shareholders’ to vote “no”—a
rare outcome for open-end mutual funds’ proxy. While ISS did not
object to Oakmark’s proposal to amend investment restrictions
nor Oakmark’s desire to amend the declaration of trust, ISS
took issue with the ability of the directors of Oakmark to remain
independent while considering the merits of shareholders’
derivative claims. The ISS report informed shareholders that
this change “could severely curtail shareholders’ rights since
investors require the fund directors’ approval before they can
bring about a lawsuit against the investment adviser. If a director
is not truly independent of that adviser, then it is highly unlikely
that the director would permit shareholders to sue the adviser.”
Additionally, ISS questioned a proposal for a “forum selection”
change, which would force Oakmark shareholders to bring claims
only in Massachusetts. Oakmark’s board argued that this forum
selection change would save litigation costs and limit forum
shopping by potential plaintiffs. ISS also took issue with the
failure of Oakmark’s proxy to mention the excessive fees charged
by investment adviser Harris Associates due to an 11-year legal
battle ending in the Supreme Court case Jones v. Harris. While
the suit was initially filed in Missouri federal court, the fund adviser persuaded a judge to move the case to federal court in Illinois, which ISS claimed did not “appear to support the board’s argument to have a Massachusetts court serve as the sole and exclusive forum” for future claims. As a consequence of the ISS report, Oakmark shareholders voted against three separate proposals, one of which ISS even supported.

**Fiduciary Rule Uncertainty Delays Issuance of Transaction Shares (“T Shares”)**

On March 5, 2017, brokerage and wealth-management arms of various banks announced that they would delay or suspend the issuance of T Shares as the DOL continues to review the fiduciary rule. T Shares would have identical sales charges across all fund categories in order to eliminate pay incentives that may cause a broker to recommend higher-cost funds over less-expensive, similar options. The fiduciary rule consequently made sales loads difficult for brokers that charge investors; thus, brokerage firms intend to offer T Shares as a solution to the fiduciary rule. Generally, firms charge a 2.5 percent fee on T Shares when sold and a “12b-1 fee” of 0.25 percent in order to cover distribution and other expenses.

**SEC ENFORCEMENT ACTIONS**

**In the Matter of Citadel Securities (Admin. Number 3-17772)**

On January 13, 2017, Citadel Securities LLC (“Citadel”), one of the largest market-makers in the United States, settled with the SEC for $22.6 million over charges that it had misled retail customers regarding the ways in which their stock orders were executed. According to the SEC complaint, Citadel Execution Services, a unit of Citadel, allegedly told investors that it would locate the best trade prices either through “internalizing,” a method involving taking the opposite side of the trade itself, or by finding the best available prices the market had to offer. To do so, Citadel utilized two algorithms known as “FastFill” and “SmartProvide.” However, FastFill immediately internalized orders that were not necessarily for the best prices, while SmartProvide routed trades to external markets and executed trades at the best price only a fraction of the time. The SEC found that these algorithms violated SEC rules. Citadel neither admitted nor denied the SEC’s allegations, but agreed to pay $5.2 million in disgorgement plus $1.4 million in interest.

**Kokesh v. Securities and Exchange Commission (Case Number 16-529, U.S.)**

On January 13, 2017, the Supreme Court of the United States agreed to hear New Mexico investment adviser Charles R. Kokesh’s appeal of a Tenth Circuit decision on whether the SEC is subject to time restrictions when seeking disgorgement. In 2009, the SEC charged Kokesh with misappropriating money from four business development companies from 1995 through 2007. After winning a jury verdict against Kokesh in 2014, Kokesh was ordered to disgorge roughly $35 million, as well as pay over $18 million in prejudgment interest and $2.4 million in penalties. While the disgorgement applied to all of Kokesh’s ill-gotten gains, the penalty only applied to Kokesh’s conduct throughout the five years prior to the SEC’s filing of the suit in New Mexico. In August 2016, the Tenth Circuit found that the five-year statute of limitations on civil penalties did not apply in Kokesh’s case and permitted the SEC to disgorge $35 million in interest. However, in May 2016, the Eleventh Circuit issued a conflicting decision holding that the SEC could not seek disgorgement for conduct older than five years. As a result of the circuit split, Kokesh filed a successful petition for certiorari to the U.S. Supreme Court.

**In the Matter of Morgan Stanley Smith Barney LLC (Case Number 3-17773)**

On January 13, 2017, Morgan Stanley Smith Barney LLC (“MSSB”), an investment advisement subsidiary of Morgan Stanley, settled with the SEC for $13 million after the SEC charged MSSB with
inadvertently overcharging clients by more than $16 million throughout a 15-year period as a result of administrative and billing system blunders. In 2009, Morgan Stanley and Citi Smith Barney created MSSB as a joint venture. According to the SEC, the two firms combined their investment accounts into a single, consolidated billing system and continued to enter client information without utilizing adequate monitoring to ensure client fee amounts aligned with advisory agreements. As a result, numerous billing errors led to over 5,000 accounts being charged the highest fee available in the system. Moreover, because negotiated rates were not always entered into the system, roughly 9,000 accounts were overcharged, and some clients were never reimbursed for advanced-billing fees even after they had terminated their accounts. MSSB also settled with the SEC for two violations of the Adviser’s Act whereby investment companies are required to have independent public accountants conduct annual surprise examinations into custodied client assets. In connection with the settlement, MSSB must research the impact of all billing errors for three years and eliminate any additional violations that may arise within the next six months. MSSB neither admitted nor denied the allegations.

**Securities and Exchange Commission v. Strategic Capital Management, LLC et al. (Case Number 1:17-cv-10125)**

On January 25, 2017, registered investment adviser Michael J. Breton of Strategic Capital Management, LLC (“Strategic”) pled guilty to criminal charges on the same day the SEC charged him with breaching his fiduciary duty by defrauding at least 30 clients over six years. According to the SEC complaint, Breton invested in public companies that reported their earnings after market hours, assessed the influence of the companies’ respective earnings reports on the value of the shares at issue, and thereafter distributed profitable shares into his personal accounts and allocated unprofitable shares into his clients’ accounts. This scheme allowed Breton to cherry-pick over 200 profitable trades for himself while leaving over 200 unprofitable trades for his clients. The SEC argued that this scheme violated Breton’s fiduciary duties owed to his clients, causing Strategic to make misleading statements assuring investors that Breton’s personal trades would not be disadvantageous for them.

**Order in the Matter of Windsor Street Capital, L.P. (Admin. Number 3-17813)**

On January 25, 2017, the SEC charged registered broker-dealer Windsor Street Capital, L.P. (“Windsor”), which does business as Myers Associates, L.P. (“Myers”), and Windsor chief compliance and anti-money laundering (“AML”) officer John Telfer with violating sections of the Securities Act relating to failing to report suspicious activity on documents known as Suspicious Activity Reports (“SARs”). The Financial Crimes Enforcement Network requires financial institutions to file SARs after a suspected incident of money laundering or fraud. According to the SEC complaint, between January 2014 and October 2014, Windsor sold hundreds of millions of penny stock shares to Raymond Barton and William Goode through issuers such as MedGen, Inc.; Alternaturals, Inc., Manzo Pharmaceuticals, Inc.; and Solpower, Inc. Barton and Goode represented that the shares were exempt under Rule 144, were held for over one year, and that the issuers were not shell companies. However, one or more of these representations were false, and Myers received roughly $120,000 in commissions from these transactions. In doing so, Windsor and Telfer failed to file SARs as required under Rule 17a-8, and according to SEC charges, Telfer aided and abetted this violation. These violations also related to Myers’ penny stock liquidation business whereby the firm regularly accepted deposits of large amounts of penny stocks for liquidation, and then customers would sell the shares and transfer out proceeds immediately. When customers filled out requisite forms to perform the trade, Myers was immediately put on notice per the firm’s AML program. In other words, customers acquired shares under wary circumstances and sold the shares as they were being promoted by the company. As such, customers continually demonstrated conduct evidencing red flags and suspicious activity under the firm’s AML program, thus requiring SARs to be filed with the SEC. The matter will be set for a hearing in the future.

**Securities and Exchange Commission v. Varacchi, et al. (Case Number 3:17-cv-00155, D. Conn.)**

On February 2, 2017, the SEC charged Connecticut investment adviser Sentinel Growth Fund Management (“Sentinel”) and its owner Mark J. Varacchi for allegedly stealing investment money from clients in order to settle private lawsuits and other expenses in violation of Section 17(a) of the Securities Act, Section 10(b) of the Securities Exchange Act, and Rule 10b-5, Sections 206(1), 206(2), and 206(4) of the Investment Advisers Act Rule 206(4)-8. According to the SEC, Sentinel and Varacchi allegedly told investors that their investments would be allocated to up-and-coming hedge fund managers; however, Sentinel and Varacchi did not transfer all of the money as disclosed to clients. Instead, the SEC claims that Sentinel and Varacchi commingled investor assets
with Varacchi’s personal funds and personally managed investor accounts, balances, and returns in order to siphon away funds. An investigation found that Sentinel and Varacchi stole at least $3.9 million from investors, $1 million of which was needed to settle a private litigation matter brought by Varacchi’s former boss. The SEC is seeking injunctive relief and disgorgement, plus interest and penalties. Two hedge funds, Radar Alternative Fund LP and Radar Alternative Master Fund SPC, both managed by Sentinel and Varacchi, have also been named as relief defendants. The SEC’s investigation is being conducted by its Asset Management Unit as well as the SEC’s Boston regional office.

Securities and Exchange Commission v. Connell (Case Number 17-00831, S.D.N.Y.)

On February 3, 2017, the SEC charged investment adviser Barry Connell with violating Sections 206(1) and (2) of the Investment Advisers Act of 1940. According to the SEC complaint, Connell allegedly obtained counterfeit authorization forms in order to conduct over 100 transactions on behalf of his clients. Connell allegedly used client money to rent a home in the Las Vegas suburbs, purchase a country club membership, and enjoy private jet service. The U.S. Attorney’s Office for the Southern District of New York also filed criminal charges against Connell in a parallel action.

In the Matter of SLRA Inc. as successor entity to Liquid Realty Advisors III, LLC and Scott M. Landress (Admin. Number 3-17826)

On February 7, 2017, the SEC permanently barred and penalized private equity adviser Scott M. Landress and his investment advisory firm SLRA Inc. ("SLRA") $1.25 million to settle charges alleging that Landress improperly withdrew fees from two private equity funds that he managed. According to the SEC, Landress established the two funds in order to invest in real estate trusts in underlying investments in properties throughout the United Kingdom. SLRA earned fees based on the net asset value of the underlying investments. Due to the financial crisis, SLRA’s fees decreased while management costs increased as real estate values of the assets in the trusts crashed. Landress’s limited partners refused his requests for additional compensation to cover expense shortfalls. The SEC’s order states that Landress instructed SLRA to withdraw $16.25 million in British pounds from the private equity funds in 2014 as payment for multiple years of services provided by an affiliate. Landress then allegedly transferred this money to his personal account. SLRA and Landress failed to disclose this transaction as a related-party transaction, as well as the resulting conflicts of interest, until after SLRA withdrew the money. The SEC’s order states that Landress and SLRA returned the withdrawn fees to the funds shortly after the SEC conducted its investigation. Landress and SLRA agreed to the SEC’s cease-and-desist order and did not admit nor deny the SEC’s findings.

In the Matter of Jeffrey Slocum & Associates (Admin. Number 3-17833)

On February 8, 2017, the SEC charged registered investment adviser Jeffrey Slocum and his firm, JSA, with violating Sections 204(a), 206(2), and 206(4) of the Investment Advisers Act by allegedly circulating marketing materials to prospective clients that made representations regarding the firm’s ethical approach to business and avoiding conflicts that were not true. JSA also failed to keep adequate books and records to support the circulated performance data. As a result, Slocum and JSA both agreed to a cease-and-desist order. Slocum also agreed to a penalty of $100,000 while the firm will pay $300,000 in penalties.

Epstein et al. v. Ruane, Cunniff & Goldfarb Inc. et al. (N.Y. Sup. Ct. Case No. 650100/2016)

On February 24, 2017, Justice O. Peter Sherwood of the State Supreme Court in White Plains, New York, dismissed a January 2016 shareholder lawsuit brought against Sequoia Fund ("Sequoia") alleging that Sequoia shareholders failed to prove that it would have been futile for the fund to demand that its directors liquidate a very costly investment in Valeant Pharmaceuticals ("Valeant") due to the directors’ alleged conflicts of interest. In 2015, Sequoia suffered billions of dollars in losses as a result of Valeant’s controversial drug pricing and distribution practices. The plaintiff shareholders (who filed suit on behalf of the fund) argued that the defendants were grossly negligent for permitting Sequoia to invest roughly 32 percent of its assets into Valeant.

Private equity fund advisers have a duty to act in the best interest of their clients, but Landress and SLRA helped themselves to millions of dollars’ worth of fees to which they had no legitimate claim.

— Scott W. Friestad
Associate Director of the SEC's Division of Enforcement
notwithstanding a fund policy limiting its stake at 25 percent. In May 2016, the plaintiffs filed an amended complaint asserting that Sequoia’s directors could not objectively evaluate a shareholder litigation demand to dismantle the Valeant investment. Ultimately, however, Justice Sherwood concluded that the complaint could not move forward, as the plaintiff shareholders failed to substantiate demand futility with respect to the directors addressing the shareholders’ claims on the Valeant investment.

*Kasilag et al. v. Hartford Investment Financial Services, LLC (Case No. 1:2011cv01083, D.N.J. 2016)*

On February 28, 2017, U.S. District Court Judge Renée Marie Bumb for the District of New Jersey ruled against various shareholders in the Hartford Funds ("the Plaintiffs") who sued Hartford Investment Financial Services ("Hartford") for excessive fees under Section 36(b) of the Investment Company Act of 1940 ("the Act"). The Plaintiffs argued that Hartford’s management fees were between three and five times higher than the amount Hartford pays sub-advisers for substantially the same or similar management services. In making her ruling, Judge Bumb analyzed each of the "Gartenberg factors," which assist judges in determining whether investment adviser fees are excessive under Section 36(b) of the Act. Those factors include: (1) the nature and quality of the services provided; (2) the profitability of the mutual fund to the adviser manager; (3) any "fall-out" benefits to the adviser; (4) economies of scale; (5) how the fee structure compares with those of other similar funds; and (6) the independence and conscientiousness of the fund’s independent directors.” The court concluded that the Plaintiffs failed to present evidence to conclude that Hartford’s fees were excessive.

*In the Matter of Sidoti & Company, LLC (Admin. Number 3-17843)*

On April 5, 2017, the SEC charged auditors William Joseph Kouser Jr. and Ryan James Dougherty of BBD LLP for failing to identify investment and fraud risks relating to consumer loans operated by the fund GL Capital Partners LLC ("Capital Partners"). In June 2016, Capital Partners’ former CEO Daniel Thibeault was sentenced to nine years in prison for securities fraud and obstructing an SEC investigation. Capital Partners and Thibeault acted as investment advisers to the GL Beyond Income Fund ("GL Beyond"). Kouser and Dougherty, as auditors for GL Beyond in 2013 and 2014, did not act with due professional care by failing to uncover the aforementioned fraud. Specifically, in 2014, the auditors did not inquire about a new type of loan, called “TA loans,” issued by GL Beyond even though the value of these new loans was significantly higher than the value of the loans typically acquired by the fund. Furthermore, Kouser and Dougherty failed to use heightened scrutiny with respect to the creation of two shell companies designed to facilitate the private placement of promissory notes. “As a result of these audit failures, respondents

For example, while Sidoti kept a “daily restricted list” of securities that employees were prohibited from personally trading in, the SEC found 126 instances where a stock that appeared in the daily restricted list was traded. Sidoti did not admit nor deny the SEC’s findings and consented to an order finding the firm in violation of Section 15(g) of the Securities Exchange Act of 1934.

**U.S. v. Yoo (Case No. 2:17-cr-00075, W.D. Wash.)**

On March 20, 2017, Washington state based investment adviser Chris Young Yoo pled guilty in exchange for a nearly seven-year sentence for allegedly defrauding clients out of $3.6 million through a Ponzi scheme. After an investigation in 2014, Yoo agreed to pay $1.3 million in penalties to the SEC and accepted a bar from the securities industry after the SEC charged him with lying to clients and failing to disclose conflicts of interest in breach of his fiduciary duty. According to the SEC complaint, Yoo continued to solicit investments for personal gain, as well as to pay investors after he had settled with the SEC in 2015. From 2006 to 2015, the SEC found that Yoo siphoned client funds into a separate account that he used to pay himself and other investors instead of investing in the South Korean market as he disclosed to his clients. Yoo agreed to pay $3.6 million in restitution and faces a potential 80-month prison sentence. Sentencing is set for June 22, 2017.

**In the Matter of William Joseph Kouser Jr., CPA, and Ryan James Dougherty, CPA (SEC Case Number 3-17898)**

On April 5, 2017, the SEC charged auditors William Joseph Kouser Jr. and Ryan James Dougherty of BBD LLP for failing to identify investment and fraud risks relating to consumer loans operated by the fund GL Capital Partners LLC (“Capital Partners”). In June 2016, Capital Partners’ former CEO Daniel Thibeault was sentenced to nine years in prison for securities fraud and obstructing an SEC investigation. Capital Partners and Thibeault acted as investment advisers to the GL Beyond Income Fund (“GL Beyond”). Kouser and Dougherty, as auditors for GL Beyond in 2013 and 2014, did not act with due professional care by failing to uncover the aforementioned fraud. Specifically, in 2014, the auditors did not inquire about a new type of loan, called “TA loans,” issued by GL Beyond even though the value of these new loans was significantly higher than the value of the loans typically acquired by the fund. Furthermore, Kouser and Dougherty failed to use heightened scrutiny with respect to the creation of two shell companies designed to facilitate the private placement of promissory notes. “As a result of these audit failures, respondents
Kouser and Dougherty did not uncover Thibeault’s and GL Capital’s fraud,” the SEC claimed. Kouser and Dougherty agreed to be barred from practicing before the SEC for at least three and two years, respectively, and both neither admitted nor denied any wrongdoing.

**Financial Industry Regulatory Authority (“FINRA”) Fines Legend Equities Corp. (“Legend”) $2.3 Million for Failing to Give Fee Discounts to Eligible Retirement Plans and Charities**

On April 5, 2017, FINRA announced that Legend was penalized $2.3 million and must pay that amount in restitution to customers who did not receive fee discounts despite being entitled to them. In May 2016, FINRA heightened scrutiny with respect to fee waivers to charities and retirement plans investing in mutual funds. Specifically, brokers were asked to disclose to FINRA:

1. whether they sold mutual fund shares to retirees and/or charities;
2. whether fee waivers were granted in such transactions; and
3. if so, whether these brokers implemented a method to ensure that customers received the discounts as promised.

According to FINRA, between 2009 and 2017, Legend denied providing charge fee discounts to roughly 4,100 eligible retirement plan and charitable organization clients. Additionally, Legend lacked the required procedures for ensuring that entitled clients actually received such discounts. Legend consented to the entry of FINRA’s findings, yet neither admitted nor denied any wrongdoing.

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