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COUNSELORS AT LAW

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Funds and Investment Management

Regulatory Update and Recent SEC Enforcement Actions

REGULATORY UPDATES

Novel Exchange Traded Fund ("ETF") to be Powered by IBM's Watson

On October 17, 2017, San Francisco-based "EquBot" announced that it is launching an ETF powered by artificial intelligence ("AI"). Through IBM's AI platform known as Watson, the ETF will seek to mirror what a team of human equity research analysts do on a daily basis. It will utilize AI to review regulatory filings, business and financial news stories, management profiles, marketplace sentiment, and other financial models for over 6,000 U.S. publicly-traded companies every day in order to create a diversified fund of 30 to 70 stocks. Once the stocks are selected, a group of human managers at ETF Managers Group will rebalance the portfolio based on the selections made by the AI.

SEC's Enforcement Division to Retreat from Previous Enforcement Strategy

On October 26, 2017, Steven Peikin, co-director of the SEC's Enforcement Division, revealed that the SEC would consider dropping its pursuit of actions involving minor legal claims as well as pulling back from requiring companies to admit wrongdoing as a settlement condition with the agency. In 2013, under former SEC Chairwoman Mary Jo White, the SEC announced that it would require companies and individuals to admit wrongdoing in certain cases as a condition of settling civil charges. It appears that the new SEC regime is backing off this policy. "I think when people resolve cases with the commission [and] neither admit nor deny but agree to all the points of relief, I don't think most people in the world say, 'Boy, they really got away with that,'" said Peikin. Nevertheless, Peikin stated that the SEC's enforcement program would continue to be tough on wrongdoers, and particularly in cases where investors lose money as well as where a defendant admits guilt in a parallel criminal case.

> ***"It may be the case that we have to be selective and bring a few cases to send a broader message rather than sweep the entire field."***
>
> ***– Steven Peikin, co-director of the SEC's Enforcement Division***

SEC to Review "Adviser" Titles; Expects More RIA Exams

On November 10, 2017, Rick Flemming, the head of the SEC's Office of the Investor Advocate, revealed at TD Ameritrade's Advocacy Leadership Summit in Washington, D.C. that the SEC will be focusing on when financial professionals may call themselves "advisers." When financial professionals hold themselves out as advisers, they are assuming a fiduciary relationship with clients. While the SEC has reviewed the issue of titles in the past—including "broker," "trusted advisor," and "financial planner"—Flemming insisted that this new effort will be more streamlined and govern all forms of verbal and written communication and advertising. The SEC is also planning to increase the amount of investment adviser exams. Currently, SEC examiners visit advisers' offices roughly once every 10 years. To increase exam frequency, the SEC recently reassigned 100 examiners to advisor firms and will increase its resources to improve the technology for exams.

> ***"What we have to make sure of is that the rule has to be no less stringent than the [Investment Advisers Act of 1940]. You have to build in exceptions to accommodate brokers' business model. You have to allow them to sell a limited line of products and proprietary products and fiduciary duty as written doesn't allow that."***
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> ***– Rick Flemming, head of the SEC's Office of the Investor Advocate.***

SEC Report: Enforcement Actions Taken against Advisers Fell during Trump's First Year in Office

On November 15, 2017, the SEC released a report stating that in fiscal year 2017, the agency pursued a total of 82 cases against investment advisers and firms compared to 98 cases in 2016. Additionally, the report revealed that the SEC filed 114 fewer enforcement actions in fiscal year 2017 than it did in 2016 with a total of 754 actions. In 2016, the SEC set a record for collecting over $4 billion in disgorgement and penalties. However, this amount decreased by nearly $300 million in fiscal year 2017 whereby parties were ordered to pay $3.8 billion in disgorgement and penalties. The SEC stated that the general decline in action and penalties collected was largely due to the Municipalities Continuing Disclosure Cooperation initiative—a self-reporting program used to highlight misstatements and omissions in municipal bond offerings.

SEC and Department of Justice ("DOJ") Directors Highlight Top Priorities under New Administration

On November 28, 2017, Stephanie Avakian, the co-director of the SEC's Enforcement Division, and Telemachus Kasulis of the DOJ laid out their respective agency's top priorities at a conference on securities regulation at the Practicing Law Institute. Avakian stated that the SEC will focus on protecting retail investors, cybersecurity, financial fraud, and insider trading; Kasulis noted that the DOJ will pursue insider trading, accounting and financial disclosure fraud, market manipulation, and cybercrimes. According to Avakian, one of Chairman Clayton's top priorities is the protection of retail investors. In particular, the SEC staff will evaluate conduct that harms retail investors, including Ponzi schemes, undisclosed fees, microcap fraud, and improper disclosure. With respect to cybersecurity, the SEC's Cyber Unit intends to focus on cases involving hackers, especially where hackers use false EDGAR filings and broadcast fake tweets. Additionally, the Cyber Unit will focus on initial coin offerings, bitcoin, and related blockchain matters; concerns here involve whether digital tokens are considered securities and whether firms provide misleading information about their use of distributed ledger and blockchain technology. Regarding fraud, Avakian noted that the SEC staff will continue to utilize updated data analytics programs to help evaluate available data about a given company. Kasulis also noted the Department's promise to focus on investigating and prosecuting individuals. Kasulis stated that the DOJ will also continue to improve on coordinating cases with federal and state regulators.

SEC Announces Delay in N-PORT Filing Requirements

On December 8, 2017, the SEC announced a delay regarding the requirement to file Form N-PORT through the EDGAR system by nine months. Form N-PORT requires registered investment companies to electronically report certain information about their funds on a monthly basis to the SEC. Under the delay, fund groups with a net asset value greater than or equal to $1 billion ("Larger Fund Groups") that previously had to submit their first reports on Form N-PORT for the period ending June 30, 2018 (due no later than July 30, 2018) will now be able to submit their first reports

on Form N-PORT by April 30, 2019. Fund groups with a net asset value of less than $1 billion will be able to start submitting reports on Form N-PORT by April 30, 2020. Additionally, Larger Fund Groups must start collecting and maintaining information required to be included on Form N-PORT by the original June 1, 2018 compliance date, although this information will not be submitted to EDGAR. The required information collected and maintained during this nine-month delay period will remain subject to all relevant recordkeeping rules and requirements, including being subject to SEC examination.

Fund Managers Seek to Create Bitcoin Exchange Traded Funds ("ETFs") as Bitcoin Futures Begin Trading

After Bitcoin futures began trading on the Chicago Board Options Exchange Futures Exchange on December 10, 2017, some fund managers have proposed launching Bitcoin-based ETFs. For example, REX Shares LLC, Van Eck Associates Corp, and First Trust Advisors LP filed proposals with the SEC to create Bitcoin-based ETFs that would use Bitcoin futures to permit investors to gain access to the Bitcoin market without having to invest directly in the coin itself. However, to date, the SEC has not yet approved any Bitcoin-based ETF proposal.

> ***"There's a real advantage, particularly in a niche ETF, to being the first one that gets to market, that gets to trading volume. We're in pretty untested territory here. There hasn't been anything like bitcoin before so there hasn't been anything like bitcoin futures before."***
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> ***– Dave Nadig, chief executive officer of ETF.com***

New SEC Leadership Appointments

On November 20, 2017, the SEC announced that Paul G. Cellupica will serve as the deputy director of the SEC's Division of Investment Management. Cellupica's duties will include overseeing strategic, rulemaking, and other industry engagement initiatives as well as act as a senior advisor to Director Dalia Blass. Cellupica was previously the managing director and general counsel for securities law at the Teachers Insurance and Annuity Association of America, and prior to that role, he was chief counsel for the Americas at MetLife, Inc. From 1996 to 2004, Cellupica served with the SEC in various roles within the Division of Investment Management and the Division of Enforcement, including assistant director in the Division of Investment Management from 2001 to 2004.

On December 18, 2017, the SEC announced that Marc P. Berger will assume the role of director of the New York regional office beginning in January 2018. Currently, Berger is the co-head of Ropes & Gray LLP's Securities and Futures Enforcement practice. Prior to joining private law, Berger was an assistant U.S. attorney in the Southern District of New York for 12 years where he supervised the investigation and prosecution of various high profile financial and investment fraud cases.

Newly Confirmed DOL and SEC Officials to Work Together to Progress Fiduciary Rule

On December 22, 2017, the U.S. Senate confirmed Preston Rutledge to be assistant secretary of labor and Hester Peirce and Robert Jackson Jr. to be SEC commissioners. Rutledge will lead the Employee Benefits Security Administration, which will have oversight of the fiduciary rule. The SEC also plans to implement its own version of the fiduciary rule, which will be overseen by Peirce and Jackson.

SEC Staff Accounting Bulletin No. 118 ("Bulletin 118"): Registered Investment Companies Affected by the Tax Cuts and Jobs Act

On December 22, 2017, SEC staff issued Bulletin 118, offering guidance to publicly-traded companies, auditors, and related parties in order to ensure timely public disclosures of the accounting effects of the Tax Cuts and Jobs Act (the "Act"). The Act includes various changes to the current U.S. tax code that will have a significant impact on corporate tax rates, business-related exclusions, and deductions and credits. In particular, the SEC issued Bulletin 118 to address the Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 740, Income Taxes ("ASC Topic 740"), in the reporting period that includes December 22, 2017. ASC Topic 740 relates to the accounting and disclosure guidance on accounting for income taxes under generally accepted accounting principles, or GAAP. The SEC staff realized that registered investment companies may encounter situations whereby the accounting for certain income tax effects of the Act will be incomplete by the time financial statements are issued for the reporting period that includes the

enactment date of the Act—December 22, 2017. As a result, the Division of Investment Management confirmed that registrants may rely on Bulletin 118 in order to calculate daily net asset values and other material provisions for which accounting would otherwise be incomplete.

ENFORCEMENT ACTIONS

SEC v. Tweed Financial Services, Inc. et al. (Case No. 17-cv-7251, C.D. Cal.)

On October 2, 2017, the SEC charged San Marino, California advisory firm Tweed Investment Services, Inc. ("TISI") with misleading investors over the profitability of a fund managed by the firm. According to SEC's Complaint, TISI and its owner Robert Russell Tweed formed Athenian Fund L.P. and collected over $1.7 million from 24 investors. Tweed and TISI promised the investors that their investment would be put into a master fund based off of a quantitative stock trading strategy. However, Tweed and TISI allegedly invested the funds in two separate investments causing a loss of over $800,000, which losses Tweed and TISI hid by issuing false and misleading account statements suggesting that the fund was profitable. Additionally, the SEC alleges that investors who were able to redeem their interests in the fund received more money than they were ever entitled to because the redemptions were calculated based on overstated asset values. Moreover, the SEC claims that Tweed and TISI had been misleading investors for years and only disclosed the losses when SEC examiners and state regulators stepped in.

SEC v. Richard G. Cody, et al. (Case No. 16-cv-12510, D. Mass.)

On October 5, 2017, former investment adviser and broker representative Richard Cody was indicted for deceiving and manipulating his former clients with respect to managing their retirement savings as well as for lying under oath to the SEC. Previously, the SEC had charged Cody with defrauding his retiree clients. The indictment was filed on September 16, 2017, charging Cody with violations under the Investment Advisers Act of 1940 and for making a false declaration in a court proceeding.

U.S. v. Scronic (Case No. 17-mj-07351, S.D.N.Y.)

On October 5, 2017, the Depart of Justice charged Westchester-based investment adviser Michael Scronic with wire and securities fraud in connection with a $19 million Ponzi scheme whereby Scronic created a fake hedge fund and used retail investor money to pay off personal bills totaling more than $500,000. According to the U.S. Attorney's Office for the Southern District of New York, Scronic told investors that their investments in his fictional "Scronic Macro Fund" were profitable when he actually lost roughly $15 million of their investments. The SEC filed a parallel complaint seeking a permanent injunction, disgorgement, and penalties. The criminal charges each carry a sentence of a maximum of 20 years in prison.

SEC v. Justin D. Meadlin and Hyaline Capital Management, LLC (Case No. 17-cv-02752, S.D.N.Y.)

On November 22, 2017, the SEC announced that Judge William H. Pauley of the U.S. District Court for the Southern District of New York entered judgments on consent against Justin D. Meadlin and his investment advisory firm Hyaline Capital Management, LLC. In the case, the SEC alleged that Meadlin and Hyaline induced potential clients and investors to invest with the firm through false and misleading tactics, including disseminating emails that materially inflated Hyaline's assets under management and promoted a fake quantitative fund. This fictitious fund claimed to have $25 million in assets under management and had positive historical returns due to a "proprietary" algorithm the firm had supposedly acquired. Meadlin and Hyaline consented to the entry of an Order enjoining them from various securities laws violations and must disgorge $150,645.66 plus prejudgment interest thereon of $12,771.39 as well as pay a civil penalty of $150,000. The SEC also barred Meadlin from the securities industry, with a right to reapply after five years.

SEC v. Louis G. Mohlman, Jr., Mohlman Asset Management, LLC, and Mohlman Asset Management Fund, LLC (Case No. 17-cv-502, N.D. Ind.)

On December 8, 2017, the SEC charged Louis G. Mohlman, Jr. and two of his investment advisory firms—Mohlman Asset Management, LLC ("MAM") and Mohlman Asset Management Fund, LLC ("MAMF")—with engaging in conflicted transactions and misleading investors. Between 2012 and 2015, Mohlman allegedly made payments to satisfy debt to third parties, and in 2013 used a private fund's assets managed by MAM and MAMF to make a $150,000 unsecured loan to a third party, which was roughly 16 percent of the fund's portfolio. Additionally, the SEC's Complaint alleges that Mohlman continued to mislead investors regarding the context of the loan even after being told by SEC examiners to fully disclose the loan to investors. The SEC also claims that Mohlman told investors to invest in his "Roth IRA

Strategy," which he stated was endorsed by tax and legal opinions; however, these statements were allegedly false. Lastly, the SEC alleges that MAMF did not correctly comply with the "Custody Rule," that MAM filed materially inaccurate Forms ADV, and that both MAM and MAMF lacked sufficient compliance programs. Mohlman, MAM, and MAMF agreed to the entry of permanent injunctions and to jointly and severally pay a $100,000 civil penalty without admitting or denying the SEC's allegations. MAMF agreed to disgorge $862.03 in ill-gotten gains plus $75.34 in interest.

SEC v. Anvil Partners, Inc. (Case No. 17-Misc-318, S.D.N.Y.)

On December 19, 2017, the SEC announced that Judge Alison J. Nathan of the U.S. District Court for the Southern District of New York ordered Buffalo, New York-based registered investment adviser Anvil Partners, Inc. ("Anvil") and its owner, president, and chief investment officer, Jeremy Beck, to be in civil contempt of court for not complying with the court's order enforcing a previously issued SEC investigative subpoena. Specifically, the SEC is looking into whether Anvil materially inflated its assets under management in its public filings. On June 6, 2017, the SEC subpoenaed Anvil to produce certain documents, yet Anvil failed to do so nor did it respond to the subpoena. Consequently, the SEC filed an enforcement action on August 21, 2017, and on September 21, 2017, the District Court ordered Anvil to comply with the SEC's subpoena. After failing to comply, the District Court held a hearing on December 19, and ultimately held Anvil and Beck in civil contempt requiring them to reimburse the SEC the cost of serving them as well as paying a $250 daily fine until both comply with the subpoena enforcement order. Beck was also ordered to be arrested and appeared at a hearing on January 10, 2018.

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