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Regulatory Update and Recent SEC Enforcement Actions

REGULATORY UPDATES

U.S. Securities and Exchange Commission ("SEC") Offers Responses to Frequently Asked Questions on New Liquidity Rule

On January 10, 2018, the Division of Investment Management issued responses to a number of questions related to Rule 22e-4 promulgated under the Investment Company Act of 1940. This new liquidity rule requires certain non-money market mutual funds and exchange-traded funds ("ETFs") to implement liquidity risk management programs aimed at protecting the interests of fund shareholders while reducing the risk that such funds will be unable to meet their redemption obligations. The questions addressed a number of topics and sub-topics, and though the Division's responses do not constitute a "rule, regulation, or statement of the Commission," they do offer meaningful insight for sub-advised funds and ETFs that meet redemptions through in-kind transfers of securities, positions, and assets (other than a *de minimis* amount of cash).

Fiduciaries Insist That the SEC Distinguish Brokers from Investment Advisers

On January 12, 2018, fiduciary groups, such as the Committee for the Fiduciary Standard (the "Committee") and the CFA Institute, sent comment letters to the SEC urging that the agency prohibit brokers from using the title of "financial adviser." In response to the pending SEC version of the controversial "Fiduciary Rule," which heightens standards by which advisers may proffer advice to clients, the aforementioned fiduciary groups complained of investor confusion caused by brokers holding themselves out as financial advisers. In particular, the Committee argued that when brokers tell clients that they are a financial adviser or wealth manager and when they advertise that they provide financial advice, investors are inherently misled. As stated in the Committee's letter, "we recommend that the [SEC] require that any title they use clearly denote their role as salespersons… Titles can range from 'salesperson' to 'broker' but may not include terms

that suggest a level of advice beyond that of stimulating the sale of a product." Investment advisers are required to register with the SEC and must act in the best interests of their clients. Meanwhile, brokers must register with the Financial Industry Regulatory Authority ("FINRA") and are held to a lesser standard of suitability, which requires brokers to sell products that merely meet an investor's objective and risk tolerance. More importantly, this lesser standard of suitability also permits brokers to recommend investments that produce the highest revenue for the broker as long as the other elements of the standard are met.

SEC Office of Compliance Inspections and Examinations ("OCIE") Reveals Top Examination Priorities for 2018

On February 7, 2018, OCIE announced its examination priorities for 2018 in an effort to enhance compliance, prevent fraud, analyze risk, and develop policy. OCIE intends to focus on the following matters:

(1) Compliance and risks in critical market infrastructure:

- OCIE will continue to examine and review providers of services critical to the functioning of markets, including, but not limited to, clearing agencies, national securities exchanges, and transfer agents, and will pay particular attention to how these entities operate and whether they comply with recently implemented rules.

(2) Matters of importance to retail investors, including seniors and those saving for retirement:

- OCIE will emphasize the "disclosure and calculation of fees, expenses, and other charges investors pay, the supervision of representatives selling products and services to investors, and the execution of customer orders in fixed income securities."
- OCIE will monitor the development of cryptocurrencies and initial coin offerings ("ICOs") with respect to registrants partaking in ICOs in order to ensure that potential investors are provided with adequate disclosures regarding the risks associated with such investments.

(3) FINRA and Municipal Securities Rulemaking Board ("MSRB"):

- OCIE will focus on FINRA's operations and regulatory programs as well as the quality of FINRA examinations of broker-dealers and municipal advisors.
- OCIE will evaluate the effectiveness of certain operations and internal policies of MSRB.

(4) Cybersecurity:

- OCIE will examine "governance and risk assessment, access rights and controls, data loss prevention, vendor management, training and incident response."

(5) Anti-money laundering ("AML") programs:

- OCIE examiners will review whether firms are properly adjusting their AML programs in response to their regulatory obligations.

SEC Chairman Reveals Outlook on Potential Revisions to the Fiduciary Duty Standard

On March 19, 2018, at a Securities Industry and Financial Markets Association event, SEC Chairman Jay Clayton revealed that a new and simplified disclosure document is being developed in order to streamline the standard of care to which advisers must adhere when advising retail investors. Chairman Clayton noted that being able to clearly explain to "mom-and-pop investors what the new standard entails is of the highest importance to the agency." Currently, investment advisers merely have to ensure that they are putting their clients' best interests ahead of their own while brokers merely have to contemplate what is suitable for their clients. Although Chairman Clayton did not specifically state what this new standard of care will be, he did mention that the SEC fully intends for such standard to become the bedrock for regulating investment advice given to retail investors and retirement savers.

"What would Ms. Smith want to know, and what would she expect from her financial professional? You can do that in a fairly short, plain-English, accessible document."

– Jay Clayton, SEC Chairman

SEC Announces New Disclosure Initiative

On February 9, 2018, the SEC announced the Share Class Selection Disclosure Initiative ("SCSDI"), which aims at using self-reporting and a standard set of terms, as opposed to investigations, to incentivize and allow investment advisers who failed to make proper disclosures to resolve such failures by self-reporting and, to the extent applicable, repay investors as a result of such failures. In its announcement, the SEC explained that the SCSDI is based on numerous enforcement actions in which investment advisers, who are also registered broker-dealers or who worked in conjunction with an affiliated broker-dealer, failed to adequately disclose conflicts of interest to their clients, including those conflicts associated with the receipt of 12b-1 fees. To be eligible for the SCSDI, an investment adviser must self-report by notifying the SEC by 12:00 a.m. EDT on or prior to June 12, 2018. An adviser who has timely self-reported must then, within 10 business days from the date of its notification to the SEC, confirm its eligibility for the SCSDI by submitting a completed questionnaire which requests certain information.

SEC Proposes to Ease Liquidity Risk Management Disclosure Requirements

On March 14, 2018, the SEC proposed amendments to reduce public liquidity-related disclosure requirements for certain open-end investment management companies. The revised requirements, which were proposed by a 3-2 vote, would replace another pending requirement that mandates funds publicly provide the aggregate liquidity classification profile of their portfolios on Form N-PORT on a quarterly basis. Instead, under the proposed amendments, funds would now discuss the operation and effectiveness of their liquidity risk management program in their annual reports. Democratic Commissioners Kara Stein and Robert Jackson opposed the change, noting that it would serve as a "rollback of transparency;" however, Chairman Clayton stated that under the proposed amendments "there is no change in the data [the SEC] will collect."

SEC Releases Best Practices to Prevent Cybercrime

On March 15, 2018, SEC Commissioner Jackson, speaking at a conference in New Orleans, made an impassioned plea to corporate lawyers across the country to do their part in fighting cybercrime and reducing its effects on corporate America, investors, and the economy. Commissioner Jackson addressed disclosure, insider trading, and internal controls as the three key issues in the current cyber war. Proposing a number of suggestions from best practices related to disclosure to internal controls for IT professionals in the event of a cyber breach, Chairman Jackson explained that cooperation between a company's legal counsel, board and information technology department, and state regulators and the SEC, is paramount to protecting investors, companies, and the American economy from the existing cyber threats.

Division of Investment Management Director Gives Keynote Address at Mutual Fund and Investment Management Conference

On March 21, 2018, speaking with confidence and optimism regarding her Division's progress and initiatives, Division of Investment Management Director Dalia Blass gave the keynote address to attendees of the ICI 2018 Mutual Funds and Investment Management Conference. In her address, Director Blass spoke of the analytical tools the Division is using to better leverage its limited staff and effectively monitor the more than 20,000 registered funds and advisers it oversees. Director Blass also discussed the Division's Board Outreach Initiative, which aims to help the Division "understand where board oversight is most valuable." The new initiative has recently sent Division staff to meet with fund boards, independent directors, counsel to independent directors, fund counsel, and independent auditors to investigate whether there is anything the Division can do "to improve the ability of fund boards to serve shareholders." Director Blass also spoke of missed opportunities for adopting a rule that governs ETFs, and that getting such regulation on the books is a "top priority."

"Our goal with this project is to understand where board oversight is most valuable."

– Dalia Blass, Director of the Division of Investment Management

For Chairman Clayton, Circuit Court Clears a Path

On March 22, 2018, by a 2-1 vote, the Fifth Circuit Court of Appeals issued a ruling to vacate the Labor Department's fiduciary rule in *Chamber of Commerce v. U.S. Department of Labor.* The Department of Labor's fiduciary rule, enacted in April 2016, set exemptions to Employee Retirement Income Security Act of 1974 ("ERISA") provisions concerning fiduciaries, and it raised considerable controversy by heightening standards for how brokers and other financial professionals serve their consumers. The majority held that the Department of Labor acted arbitrarily and capriciously in enacting its fiduciary rule and that it improperly went beyond the scope of its delegated administrative authority. The Circuit Court's ruling appears to clear a path for Chairman Clayton to enact a new and simplified framework for regulating investment advice for individuals, a framework about which Chairman Clayton has been vocal in the past. At the Securities Industry and Financial Markets Association's meeting in Florida just days before the Circuit Court's decision, Chairman Clayton discussed this desire and hinted at a simplified disclosure document which would serve as the linchpin for his new standard, the aim of which would be to clearly explain matters to individuals and average retirement savers.

ENFORCEMENT ACTIONS AND CASES

Raymond J. Lucia, et al. v. SEC
(Case No. 17-130, D.C.C.)

On January 12, 2018, the U.S. Supreme Court granted certiorari to determine whether the SEC's hiring of administrative law judges was in violation of the Appointments Clause of the U.S. Constitution in an effort to resolve a "circuit split" between the D.C. Circuit Court of Appeals and the Tenth Circuit Court of Appeals. On September 5, 2012, the SEC charged Raymond Lucia with securities fraud when he misled investors with his "Buckets of Money" investment strategy. On July 9, 2013, an administrative law judge found that Lucia's claims that his strategy had been empirically backtested were false and fined Lucia personally $50,000. The judge also barred him and his company, Raymond J. Lucia Companies Inc., from the industry, and fined the company $250,000. Lucia successfully appealed this decision to the Supreme Court, where he will argue that the SEC's administrative law judges are "inferior officers" who exercise significant decision-making authority, are covered by the Appointments Clause, and, therefore, do not have the power to hear his case. Specifically, inferior officers must be appointed by the President, the head of a federal agency, or by a court. The SEC will counter that the administrative law judges are merely SEC employees hired to make a decision in the case. In 2016, the D.C. Circuit sided with the SEC and found that the administrative law judges are employees rather than officers, as their decisions are not final and remain subject to SEC review. However, this line of reasoning runs counter to the Tenth Circuit, which in May 2017 ruled in a similar case that the SEC violated the Constitution with respect to how the agency appointed its judges. Adding to the legal controversy, in November 2017 the Trump administration stated in a brief that it would no longer subscribe to the SEC's position that its judges are employees and instead are inferior officers, and urged the Court to take up Lucia's case. The Court is expected to decide the case by the end of June.

SEC v. Hoplon Financial Group et al.
(Case No. 8:18-cv-00047, C.D. Cal.)

On January 22, 2018, the SEC charged California-based Hoplon Financial Group, its CEO Daniel B. Vazquez, Sr., and its former COO Gilbert Fluetsch with fraud for lying to investors involved in a real estate-related securities offering. According to the SEC's complaint, Hoplon, Vazquez, and Fluetsch established the New Economic Opportunities Fund I, LLC (the "Fund"), presumably to pool investments to purchase and then sell real estate. Between 2011 and 2014, Hoplon and Vazquez raised $2.18 million by allegedly selling membership units in the Fund to 27 investors, largely from the investors' individual retirement accounts and misrepresented how much compensation the Fund would receive in connection therewith. The complaint also alleges that most of the funds were misused to pay off unrelated business and personal expenses, including roughly $780,000 that had been misappropriated over time since January 2013. Additionally, by promoting and selling the underlying securities, the SEC alleged that Hoplon and Vazquez, a state-registered investment advisor and representative of a broker-dealer, respectively, violated various federal broker-dealer registration regulations.

Gray et al. v. TD Ameritrade Inc. et al.
(Case No. 1:18-cv-00419, N.D. Ill.)

On January 22, 2018, Thackery and Yelena Gray, as part of a putative class, sued TD Ameritrade Inc. and one of its investment advisers arguing that the investors lost a substantial amount of money through a trading strategy that TD Ameritrade claimed was stable and conservative. The Grays alleged that TD Ameritrade had been incentivized to refer its clients to Indianapolis-based investment advisory firm Sheaff Brock Investment Advisors LLC ("Sheaff Brock"), which then sold the Grays on a "put options income" trading strategy. According to the Grays, Sheaff Brock insisted that this investment strategy was low-risk and a "cash flow sausage factory;" however, it turned out to be extremely risky and caused the Grays to lose a substantial amount of their investment. The Grays stated that Sheaff Brock misrepresented the investment program in order to secure TD Ameritrade's wealthiest and most loyal clients. According to the complaint, TD Ameritrade requires a minimum of $500,000 in investible assets in order to participate in its "AdvisorDirect" program, which brought the Grays to Sheaff Brock. The Grays stated that the agreement with Sheaff Brock described the put options income strategy as an investment program that allowed investors to speculate on future stock prices they already own and sell contracts to potential buyers. "The 'put options' income trading strategy that Sheaff Brock executed and TD Ameritrade monitored, however, was aggressive, high-risk, and often involved 'in-the-money' put options," the complaint stated. "Not only was the trading strategy different and considerably riskier than the agreed upon strategy, it was also regularly unsuccessful and generated significant losses. Plaintiffs and the putative classes have lost significant amounts of money as a direct result of defendants' conduct and breaches of their contractual fiduciary duties and other contractual duties." The Grays' suit claims that TD Ameritrade and Sheaff Brock violated the Illinois Consumer Fraud and Deceptive Business Practices Act as well as committed breach of contract.

SEC v. Strong Investment Management, et al.
(Case No. 8:18-cv-00293, C.D. Cal.)

On February 20, 2018, the SEC filed a complaint against California-based investment adviser Strong Investment Management ("Strong") and its president and sole owner, Joseph B. Bronson, for allegedly operating a "cherry picking" scheme. Additionally, the SEC's complaint alleges that John B. Engebretson, Bronson's brother and Strong's former chief compliance officer ("CCO") relinquished compliance duties and disregarded multiple "red flags" in connection with the scheme. According to the SEC, Bronson traded in Strong's omnibus account, but held off allocating securities to specific client accounts until he reviewed the performance of a given security over the trading day. Essentially, Bronson "cherry picked" the trades by allocating profitable trades to himself and unprofitable trades to Strong's clients. Also, the SEC complaint states that Strong and Bronson misrepresented these allocation practices on Strong's Form ADV, such as by incorrectly stating that trades would be allocated according to pre-trade allocation statements and that Strong made assurances that it did not favor any particular account, including those belonging to Strong's personnel. The SEC also alleges that Engebretson failed in his duties as CCO by not ensuring that Strong had policies and procedures in place regarding trade allocation practices and by ignoring the various red flags relating to such practices. The SEC is charging Bronson and Strong with violating Section 10(b) of the Exchange Act and Rule 10b-5 thereunder as well as Sections 17(a)(1) and 17(a)(2) of the Securities Act of 1933, and Sections 206(1), 206(2), and 207 of the Investment Advisers Act of 1940. The SEC also alleges that Strong violated Section 206(4) of the Investment Advisers Act and Rule 206(4)-7 promulgated thereunder, and that both Bronson and Engebretson aided and abetted those violations.

***SEC v. Commonwealth Advisors, Inc. and Walter A. Morales* (Case No. 3:12-cv-00700, M.D. La.)**
On February 15, 2018, Honorable John W. deGravelles of the U.S. District Court for the Middle District of Louisiana entered a final judgment against Walter A. Morales ("Morales") and Commonwealth Advisors, Inc. ("Commonwealth") after Morales agreed to be barred from associating with any investment adviser and Commonwealth consented to have its license with the SEC revoked for their collective involvement in an investment scheme during the financial crisis of 2012. In November 2012, the SEC charged Morales and Commonwealth with allegedly defrauding investors by covering up losses from investments made in residential mortgage-backed securities ("RMBS"). Morales and Commonwealth allegedly directed the hedge funds that they managed to buy the lowest and riskiest tranches of a collateralized debt obligation ("CDO") known as "Collybus." Then, both sold mortgage-backed securities into the CDO at prices obtained four months prior while aware that the RMBS market continued to rapidly decline. While the CDO investments performed poorly, Morales told Commonwealth employees to conduct cross-trades between the hedge funds that they advised in order to mask a $32 million loss of one of Commonwealth's Collybus investment funds. Thereafter, Morales and Commonwealth allegedly misled investors regarding the amount and value of mortgage-backed assets held in the hedge funds through fake internal documents used to inflate their valuations. Judge deGravelles' final judgment orders Morales to pay a $130,000 penalty and permanently enjoins Morales and Commonwealth from various securities law violations. Morales and Commonwealth settled with the SEC without admitting or denying the allegations.

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