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Regulatory Update and Recent SEC Actions

REGULATORY UPDATES

U.S. Securities and Exchange Commission ("SEC") Proposes Rule Change to Address Auditor Independence

On May 3, 2018, the SEC proposed to amend its auditor independence rule, Rule 2-01 of Regulation S-X (the "Loan Rule"), in response to a conclusion that the Loan Rule is not currently working as intended and could have "broader disruptive effects, particularly for funds." The SEC acknowledged that the Loan Rule should be amended to focus on debtor-creditor relationships that may impair an audit firm's impartiality. The proposed amendments aim to (1) limit the Loan Rule's analysis solely to beneficial ownership without considering record ownership; (2) replace the current 10 percent test (used to identify beneficial ownership of an audit client's equity securities) with a "significant influence" test; (3) implement a "known thorough reasonable inquiry" compliance standard to identify beneficial owners of an audit client's equity securities; and (4) exclude other funds that would be considered affiliates of the audit client from the definition of "audit client." The SEC believes that shifting the focus to beneficial owners would more effectively identify audit client shareholders who have a special or influential role with respect to the audit client and, therefore, would better capture debtor-creditor relationships that can impair an audit firm's independence. Similarly, the significant influence test would focus on a lender shareholder's ability to influence the policies and management of an audit client and would be based on all facts and circumstances. The test would include consideration of the level of a lender's beneficial ownership, but a bright-line percentage ownership test by itself would no longer be dispositive regarding an auditor's independence with respect to an audit client.

U.S. Department of Labor ("DOL") Issues Temporary Non-Enforcement Policy for Fiduciary Rule

On May 7, 2018, the DOL released Field Assistance Bulletin 2018-02 (the "FAB") in response to the Fifth Circuit's decision in *Chamber of Commerce of the U.S.A., et al. v. U.S. Dep't of Labor, et al.* The FAB provides that financial advisers may continue to rely on the DOL's temporary

enforcement relief policy as adopted under Field Assistance Bulletin 2017-02, and it stated that the DOL will not pursue claims against investment advice fiduciaries who are working diligently in good faith to comply with the conduct standards applicable to the "Best-Interest Contract Exemption" or the "Principal Transaction Exemption." The DOL also will not treat such investment advice fiduciaries as violating the prohibited transaction rules. The DOL will issue additional guidance in the future with respect to other forms of temporary or permanent options that may be available to financial advisers, but provided no additional advice now.

President Trump Nominates Replacement for SEC Commissioner Piwowar

On June 1, 2018, President Trump nominated Elad Roisman to replace SEC Commissioner Michael Piwowar. Piwowar, a Republican originally appointed to the SEC by President Obama in 2014, announced on May 7, 2018, that he would resign on the earlier of July 7, 2018, or the swearing in of his successor. Roisman, a former Milbank Tweed Hadley & McCloy LLP attorney, currently serves as chief counsel to the Senate Committee on Banking, Housing, and Urban Affairs. The timing of Roisman's Senate confirmation may be crucial to the commission avoiding becoming embroiled in deadlock if left with a vacancy and only four commissioners. If confirmed by the Senate, Roisman would serve a five-year term ending in 2023.

SEC No-Action Letter Provides Cover for Mutual Fund Transfer Agents Delaying Redemptions to Prevent Financial Exploitation of Elderly or Vulnerable Adults

On June 1, 2018, the SEC Division of Investment Management granted No-Action relief permitting mutual funds and their SEC-registered transfer agents to delay disbursement of proceeds from the mutual fund accounts of elderly or otherwise vulnerable adult shareholders ("Specified Adult"), thus, the SEC stated it would not recommend enforcement actions against any mutual fund or its SEC-registered transfer agent under Section 22(e) of the Investment Advisor Act of 1940, if the transfer agent (acting on the mutual fund's behalf) delays (for more than seven days) the disbursement of redemption proceeds from the mutual fund account of a Specified Adult where the transfer agent has a reasonable belief of financial exploitation. The No-Action relief is consistent with how broker-dealers must conduct themselves in similar situations under FINRA Rule 2165.

SEC Modernizes Fund Shareholder Reporting

On June 5, 2018, the SEC voted to adopt a new rule, Rule 30e-3, under the Investment Advisor Act of 1940 (the "Rule"), which modernizes how mutual funds and certain other registered investment companies ("funds") may deliver required periodic reports to their shareholders. Under the Rule, subject to certain conditions, funds can satisfy their obligations to transmit annual and semi-annual reports to shareholders under Rule 30e-1 and Rule 30e-2, respectively, by making them "publically accessible, free of charge, at a website address specified in a written notice to shareholders." Shareholders who prefer paper can continue to receive shareholder reports in that manner. The Rule is subject to a two-year transition period, meaning it will take effect no earlier than January 1, 2021. The commission has requested that investors and other interested parties provide feedback and public comment until October 31, 2018.

Merrill Lynch to Re-Assess its Individual Retirement Accounts ("IRA") Policies in Wake of Shifting Regulations

On June 15, 2018, Merrill Lynch announced that in light of the Fifth Circuit Court of Appeals vacating the DOL's Fiduciary Rule, it has decided to review its policy on commission-based IRAs. In a public statement, Merrill Lynch said that because "the regulatory environment has shifted, we're taking a look at our policies, especially as they might affect policies and procedures for Individual Retirement Accounts, to ensure we keep our clients' best interest front and center." The move by Merrill Lynch, a company that has nearly 15,000 financial advisers, may be an early indicator of how the industry will address client needs under the changing regulatory framework.

SEC Reveals Five-Year Forecast on Priorities

On June 19, 2018, SEC Chairman Jay Clayton announced that the agency is seeking public opinion on shaping its priorities over the next five years. In a draft strategic plan, the SEC focused on three areas: (1) protecting Main Street Investors, (2) trends in the capital markets space, and (3) improving the SEC's workforce. First, the chairman indicated in a report that protecting Main Street will be the most important priority, stating, "When [Main Street

investors] seek professional advice, their choices all too often are not as clear as they should be. The distinction between investment professionals who sell securities and those who provide investment advice has become less clear. This lack of clarity makes it challenging for investors to understand what standards of conduct govern the investment professionals who assist them.” Secondly, the SEC intends to focus on emerging trends in the capital markets space, including data security and electronic platforms. As stated in the draft plan, “As technological advancements and commercial developments have changed how our securities markets operate and spurred the development of new products, the SEC’s ability to remain an effective regulator requires that we continually monitor the market environment—and adapt. We should expand our focus, expertise and, as necessary, our scope of operations in vital areas such as market monitoring analysis, market operations, including clearing and settlement, and electronic trading across our equity, fixed-income and other markets.” Lastly, the SEC fully expects to improve its analytical capabilities and development of human capital.

ENFORCEMENT ACTIONS AND CASES

SEC Enforcement Actions against Public Companies Continue to Decline

As of March 31, 2018, the SEC initiated only 15 new enforcement actions against public companies in the first half of the fiscal year, nearly 70 percent less than the first half of FY 2017. The SEC is on pace to bring the lowest number of enforcement actions since the first half of FY 2013. According to the Securities Enforcement Empirical Database (“SEED”), the SEC settled 87 percent of public company and subsidiary actions on the same day they were initiated, with 56 percent of defendants cooperating with the agency. Of those charged, 10 of the public company and subsidiary actions lacked an individual defendant. In the actions that did involve an individual defendant, four were related to issuer reporting and disclosure allegations. In addition, 10 of the actions involved the finance, insurance, and real estate industries. Both total and average monetary settlements were the lowest semiannual amounts in SEED’s dataset. As over half of the actions were settled, the monetary settlements declined to $65 million, making the average settlement just $4.3 million. This is significantly lower than the next-lowest semiannual average of $13.3 million in the second half of FY 2015. Moreover, the largest monetary settlement was only $14 million, which is the lowest amount in any prior half years.

SEC v. Lisa A. Esposito (No. 13-05680, E.D.P.A.)

On April 26, 2018, the U.S. District Court for the Eastern District of Pennsylvania entered a judgment against Lisa A. Esposito, a registered representative associated with Meeting Street Brokerage, LLC, permanently enjoining her from future violations of Section 10(b) and Rule 10b-5 of the Exchange Act. According to the SEC’s complaint, Esposito aided and abetted two of her co-defendants in manipulating the market for shares of two publicly traded companies, Visolar, Inc. and FACT Corporation. Esposito introduced the co-defendants to a consultant who assisted the co-defendants in creating the appearance of market interest for the companies to induce public purchases of the stocks and artificially increase stock trading price. In exchange, Esposito received a portion of the kickback paid to the consultant. On May 21, 2018, Esposito settled with the SEC; she is barred from associating with any broker, dealer, investment adviser, municipal securities dealer, or transfer agent, pursuant to Section 15(b)(6) of the Exchange Act.

SEC v. Villena (No. 1:18-cv-04309 S.D.N.Y.)

On May 15, 2018, the SEC charged four individuals for their roles in a fraudulent scheme that produced nearly $34 million from unlawful stock sales. The SEC filed the action against Francisco Abellan Villena, Guillermo Ciupiak, James B. Panther Jr., and attorney Faiyaz Dean, charging the defendants with violating antifraud and registration provisions of the federal securities laws. According to the SEC complaint, the defendants manipulated the market for and illegally sold the stock of microcap issuer Biozoom Inc. They allegedly hid their ownership and sales of Biozoom shares by using offshore bank accounts, sham legal documents, a network of nominees, anonymizing techniques, and other deceptive practices. The SEC obtained a court order in 2013 freezing proceeds from the unlawful Biozoom sales. It subsequently obtained a default judgment and established a fund, which has returned more than $14 million to harmed investors. The SEC previously obtained a judgment against Abellan for his role in another

market manipulation scheme and charged a lawyer and officer of Biozoom's predecessor entity. Additionally, the SEC charged two registered representatives, in separate actions, for their roles in the unregistered sales of Biozoom stock and a brokerage firm for supervisory and recordkeeping failures.

***SEC v. William M. Jordan* (No. 8:18-cv-00852, C.D. CAL)**

On May 15, 2018, the SEC announced that investment adviser William Jordan had settled charges for perpetuating a multimillion dollar fraud on his clients. The SEC's complaint alleged that from 2011 through 2016, Jordan raised more than $71 million, from roughly 100 clients, by allegedly lying about how funds would be invested, his performance, and his own disciplinary history in the securities industry. He purportedly overstated the value of his 16 private investment funds and then used the inflated values and unrealized profits on other investments to overpay management fees and bonuses to himself. The SEC's complaint charged Jordan with violating the antifraud provisions of federal securities laws, including the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Advisers Act of 1940. Jordan settled the action by consenting to the entry of a permanent injunction and did not admit or deny the allegations of the Complaint. The Federal District Court in Orange County, California will determine the appropriate amount of disgorgement, prejudgment interest, and civil penalties.

***SEC v. Brent Borland, et al.* (No. 18-cv-4352, S.D.N.Y.)**

On May 16, 2018, the SEC charged Brent Borland and two of his companies with misappropriating roughly six million dollars of his investors' money. According to the SEC's complaint, between 2014 and 2017, Borland sold over $21.9 million of promissory notes to dozens of investors. He promised that the investments would be used as a bridge loan for developing an airport in Belize and would be secured by pledges of real estate as collateral. The notes were promoted and sold to investors through Borland's companies, Borland Capital Group LLC, which claims to be active in "alternative investment," and Belize Infrastructure Fund I, LLC, which asserts that it is in the construction finance business. The SEC alleged that Borland used investor funds for personal expenses, and other unrelated business expenses, including mortgage and property tax payments on his Florida mansion, multiple luxury cars, private school tuition for his children, a beach club membership, and nearly $2.7 million to pay off credit card debt. Borland also allegedly deceived investors by pledging the same collateral to multiple individuals. After the notes passed without repayment and slipped into default, the SEC charged Borland and his two companies with violating Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Act of 1934 and Rule 10b-5 thereunder. The SEC is seeking asset freezes against Borland and his multiple holding companies, an accounting of investor assets, disgorgement of ill-gotten gains, and civil penalties.

SEC Charges Brokerage Firms with Anti-Money Laundering Violations

On May 16, 2018, the SEC settled charges against broker-dealers Chardan Capital Markets LLC ("Chardan") and Industrial and Commercial Bank of China Financial Services LLC ("ICBCFS") for failing to report suspicious sales of billions of dollars in penny stock shares. Broker-dealers are required to file Suspicious Activity Reports for transactions suspected to involve fraud or no apparent lawful purpose. The SEC found that both firms violated the Exchange Act of 1934 and an SEC financial recordkeeping rule. Further, the SEC alleged that Chardan's anti-money laundering officer, Jerad Basmagy, aided and abetted the firm in these violations. Without admitting or denying fault, the parties agreed to settlements requiring Chardan to pay a one million dollar million penalty, ICBCFS to pay $860,000, and Basmagy to pay $15,000. The SEC's investigation was conducted in conjunction with Financial Industry Regulatory Authority ("FINRA"), who alleged financial, recordkeeping, and operational violations. FINRA then settled the action against ICBCFS in which the firm agreed to pay a $5.3 million penalty and hire an independent compliance consultant.

SEC Charges 13 Private Fund Advisers for Filing Infractions

On June 1, 2018, the SEC settled with 13 private fund advisers for repeatedly failing to file annual reports on Form PF, which discloses to the SEC which private funds the advisers advise and other information, such as the

amount of assets under management, the fund's strategy and performance, and the use of borrowed money and derivatives. Since 2012, private fund advisers managing over $150 million have been required to make such filings to the SEC. This critical data is used by the SEC to monitor industry trends, inform rulemaking, identify compliance risks, and target examinations and enforcement investigations. Most important to consumers, the SEC uses the information and statistics derived from Form PF data to produce quarterly reports informing the public about the private fund industry. Each of the advisers agreed to pay a $75,000 civil penalty without admitting or denying the SEC's findings. The private fund advisers are: Bachrach Asset Management Inc., Biglari Capital LLC, Brahma Management Ltd., Bristol Group Inc., CAI Managers & Co. LP, Cherokee Investment Partners LLC, Ecosystem Investment Partners LLC, Elm Partners Management LLC, HEP Management Corp., Prescott General Partners LLC, RLJ Equity Partners LLC, Rose Park Advisors LLC, and Veteri Place Corp.

Lucia v. SEC **(U.S., 2018)**

On June 21, 2018, in *Lucia v. SEC,* the Supreme Court of the United States held that SEC's Administrative Law Judges ("ALJs") were unconstitutionally appointed, reasoning that they qualify as Officers of the United States under the Constitution and are therefore subject to the Appointments Clause of the Constitution. In the case, Raymon Lucia challenged the sanctions imposed against him by arguing that the ALJ in his case was not constitutionally appointed. The Supreme Court explained that because SEC ALJs exercise "significant authority pursuant to the laws of the United States," they are inferior "Officers" under the Appointments Clause and must be appointed by the President, the SEC itself, or a court of law, rather than by agency staff, which is how ALJs are currently appointed. The Court's decision will undoubtedly effect a range of federal agencies that appoint and rely on ALJs. Among the most pressing questions related to the Court's decision are whether past ALJ decisions in SEC matters can be reopened, and whether constitutional challenges to SEC ALJs' statutory removal protections will be forthcoming. Without a doubt, respondents will now seek to re-open prior SEC ALJ decisions on the basis that the presiding ALJ was unconstitutionally appointed, but it remains unclear whether challengers failing to timely raise the constitutionality of their ALJ's appointment will succeed in re-opening their adjudications.

SEC v. James VanBlaricum, et al. **(No. 4:18-cv-518, N.D.T.C)**

On June 26, 2018, the SEC filed a complaint against James VanBlaricum and six others for running an oil and gas Ponzi scheme and violating Sections 5(a), 5(c), and 17(a) of the Securities Act and Sections 10(b) and 15(a) of the Exchange Act and Rule 10b-5 thereunder. The complaint alleges that VanBlaricum was the driving force behind a company called Texas Energy Mutual, LLC ("TEM"). Since he was a securities fraud recidivist with a history of running fraudulent schemes, VanBlaricum concealed his involvement by recruiting others to serve as TEM's public faces while secretly controlling the operation. From at least May 2013 through August 2016, the defendants defrauded hundreds of investors out of more than $10 million in connection with various securities offerings conducted for the purported purposes of drilling oil and gas wells and investing in leased mineral interests and drilling-related equipment. VanBlaricum falsely guaranteed a 10 percent annual return and full repayment of the promissory note within three years. Instead, the defendants misappropriated the funds, spending them on personal expenses including a dating website and luxury international vacations. When investors became dissatisfied and disgruntled, VanBlaricum created a "special needs" program to keep them from discovering the fraudulent conduct. In August 2016, VanBlaricum was arrested. He was sentenced to seven years in prison and was ordered to pay restitution up to $32,370,943.25.

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