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Regulatory Update and Recent SEC Actions

REGULATORY UPDATES

The U.S. Securities and Exchange Commission ("SEC") Rule Permitting Electronic Delivery of Materials as Default Method Faces Backlash

On August 8, 2018, the Coalition for Paper Options ("CPO"), which represents consumer groups and print communication companies, petitioned the U.S. Court of Appeals for the D.C. Circuit to review SEC Rule 30e-3, which was adopted on June 4, 2018. Rule 30e-3 permits mutual funds to make annual and semi-annual performance reports and other required materials accessible online free of charge to the public and allows funds to mail a paper notice of the same to investors. In order to rely on Rule 30e-3, funds must make (1) shareholder reports, (2) the most recent prior report, and (3) the last fiscal year's quarterly holdings report available online while abiding by certain format and location requirements. CPO's petition argued that Rule 30e-3 is "arbitrary and capricious and otherwise not in accordance with the law, and does not promote protection of consumers or efficiency, competition, and capital formation." CPO also argued that making electronic delivery the default distribution method imposes a burden on certain investors. "It also imposes hardship on seniors, Americans in rural areas, and other investors least able to manage the change, while opening the door to new phishing scams and cybersecurity threats," said CPO executive director John Runyan. The petitioners are also seeking a permanent injunction against the SEC's ability to implement and enforce the rule.

SEC to Review Denial of Applications for Bitcoin-Based Exchange-Traded Funds

On August 22, 2018, the SEC Staff rejected applications for nine bitcoin-based exchange-traded funds ("ETFs") due to their noncompliance with the Exchange Act of 1934. The Staff had previously rejected a bitcoin ETF

application due, in part, to concerns over manipulation of bitcoin. The SEC's decision to review the Staff's disapproval orders for the nine bitcoin ETFs is consistent with the SEC's option to review actions delegated to its Staff. While it is unclear what the SEC will decide, the willingness to review its Staff's decision provides hope to the cryptocurrency community that a bitcoin ETF may be permitted in the future.

ENFORCEMENT ACTIONS AND CASES

SEC v. Temenos Advisory, Inc. (Case No. 3:18-cv-001190, D. Conn.)

On July 18, 2018, the SEC filed a complaint against George L. Taylor and his Connecticut-based firm Temenos Advisory Inc. ("Temenos") for allegedly collecting hidden commissions and related financial incentives in luring clients toward making high-risk investments in four private companies. According to the SEC's complaint, Taylor and Temenos obscured the risks from clients by inflating the profitability of the illiquid private placements as they were paid in commissions as unregistered broker-dealers. Before 2014, Taylor and Temenos typically invested client money in mutual funds, ETFs and variable annuities and charged clients a standard fee for those services. However, from 2014 through 2017, the SEC claims that Temenos began aggressively recommending investments in four private companies and invested over $19 million into these companies' securities. Additionally, the SEC complaint states that Taylor and Temenos neglected to conduct basic due diligence on the four companies and never told clients about the financial stability of the four companies, their business prospects, or about the sustainability of the investments. The SEC alleges that Taylor and Temenos were offered finder's fees between 2.5 percent and 10 percent of the investments secured, which were inherently illegal because Taylor and Temenos were not registered broker-dealers. Taylor and Temenos were sued for two claims of investment adviser fraud—one count of acting as an unregistered broker-dealer and one count of failing to abide by written policies—and procedures as mandated by securities law.

> ***"Through their conduct, Temenos and Taylor violated the fiduciary duty that every investment adviser owes to its clients and prospective clients—to put client interests first, to deal with clients with the utmost honesty, to disclose all conflicts or potential conflicts of interest, and to use reasonable care in providing investment advice," the SEC said. "Instead, defendants ignored their clients' interests and biased their investment advice to put money in their own pockets."***

In Re BlackRock Mutual Funds ("BlackRock") Advisory Fee Litigation (Case No. 3:14-cv-01165)

On August 20, 2018, plaintiff shareholders of two BlackRock mutual funds alleged in New Jersey district court that they paid excessive advisory fees of approximately $280 million per year relative to the amount of fees that other funds receive for providing similar advisory services. The complaint states that these fees were not a result of an arm's-length negotiation, but rather in connection to the value of the services received, including portfolio management, legal and compliance monitoring, regulatory reporting, securities valuation, recordkeeping, and proxy voting coordination. BlackRock Advisors LLC, BlackRock Investment Management LLC, and BlackRock International Ltd. (collectively, the defendants) responded that the fees were justified, and are allegedly less than the industry medium. Defendants stated that the service fees are determined by the percentage of assets under management ("AUM"), and court records showed that BlackRock's AUM increased from $23 billion to $58 billion between 2007 and 2013. The complaint was originally filed in February 2014,

alleging that BlackRock breached its fiduciary duty by receiving highly-disproportionate service fees relative to the services being offered and that the fees bore "no reasonable relationship to the value of the services provided" to the shareholders and, in doing so, the defendants failed to appropriately share the benefits of scale with the shareholders as well.

SEC v. Robbins et al. **(Case No. 1:18-cv-23368, S.D. Fla.)**

On August 20, 2018, the SEC alleged that defendants Barry M. Kornfeld, Ferne Kornfeld, Lynette M. Robbins, Andrew G. Costa, Albert D. Klager, and four of their companies sold to more than 1,600 retail investors over $243 million worth of unregistered securities of bankrupt Woodbridge Group of Companies LLC ("Woodbridge"). Woodbridge went out of business last year after it was caught by the SEC for running a $1.2 billion Ponzi scheme. According to the SEC's complaint, the defendants, who were not registered broker-dealers, allegedly earned millions in commissions on the sales of Woodbridge securities as unauthorized brokers. The SEC claims that the defendants marketed Woodbridge as "safe and secure" investments and sought potential investors at a Florida university retirement and income planning class they taught. The SEC is seeking the return of ill gotten gains plus interest and penalties against the defendants and their companies. Separately, Robbins and her company Knowles Systems settled with the SEC by returning one million dollars without admitting or denying the allegations, and also paid $100,000 in civil fines.

In the Matter of Merrill Lynch Pierce Fenner & Smith Inc. **("Merrill Lynch") (Case No. 3-18651)**

On August 20, 2018, Merrill Lynch agreed to pay $8.9 million to the SEC in connection with claims that it failed to disclose a conflict of interest to customers with respect to offering certain investment products managed by a third-party adviser. On August 20, 2018, the due diligence unit at Merrill Lynch's Global Wealth and Retirement Solutions concluded that various investment products should have been terminated after a subsidiary of an anonymous foreign multinational bank convinced Merrill Lynch's governance committee to retain the investments. Over 1,500 of Merrill Lynch's retail advisory clients invested roughly $575 million into the products prior to their termination. Merrill Lynch, without admitting or denying the SEC's allegations, agreed to be censured and to disgorge over four million dollars in fees plus prejudgment interest totaling over $800,000.

Jalbert v. SEC **(Case No. 1:17-cv-12103, D. Mass.)**

In October 2017, Craig Jalbert filed a class action lawsuit against the SEC in his capacity as a trustee of the "F2 Liquidating Trust" challenging whether disgorgement was an available remedy for the SEC, which had allegedly illegally collected approximately $15 billion in disgorgement penalties. On August 22, 2018, U.S. District Court Judge F. Dennis Saylor IV ruled that the U.S. Supreme Court's decision in *Kokesh v. SEC* did not prohibit the SEC from collecting disgorgement payments. In the suit, F-Squared Investment Management LLC's ("F-Squared") liquidation trustee argued that the *Kokesh* ruling prohibited the SEC from "double dipping" by collecting both disgorgements and penalties in civil or administrative enforcement actions. In 2017, *Kokesh* held that the SEC is subject to a five-year statute of limitations with respect to collecting civil penalties. F-Squared claimed that the SEC used disgorgement as a means to tack on additional penalties including a $30 million penalty that F-Squared agreed to pay prior to filing for bankruptcy, while the SEC argued that *Kokesh* merely instituted a five-year statute of limitations on the agency's ability to obtain ill-gotten gains. Judge Saylor ruled that the SEC retains the right to collect disgorgement under the 1990 Penny Stock Reform Act stating, "an action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise" must be "commenced within

five years from the date when the claim first accrued." Additionally, Judge Saylor ruled that *Kokesh* "did not change the ability of the SEC to collect disgorgement in civil enforcement proceedings and "that opinion says nothing about the application of disgorgement in administrative proceedings."

Attorneys have been questioning the SEC's disgorgement power based on a footnote written by Justice Sonia Sotomayor in the Kokesh decision, which said, "Nothing in this opinion should be interpreted as an opinion on whether courts possess authority to order disgorgement in SEC enforcement proceedings or on whether courts have properly applied disgorgement principles in this context." Judge Saylor dismissed the Jalbert dispute because the SEC had the authority to enter a disgorgement order at the time, and F-Squared had entered into a binding settlement with the SEC in which it expressly waived judicial review.

Obeslo et al. v. Great-West Capital Management ("Great-West") (Case No. 16-230, D. Colo.)

On September 12, 2018, U.S. District Judge Christine Arguello rejected plaintiff investors' argument accusing Colorado investment advisor Great-West of charging the investors excessive management fees, and thereby breaching its fiduciary duty to the investors under the U.S. Investment Company Act of 1940 (the "40 Act"). Under the 40 Act, an advisor is in breach of its fiduciary duty if its compensation is disproportionate to the services it provides. The investors argued that they had standing to sue for fees charged in connection with 63 mutual funds managed by Great West because the funds were issued in a single series, even though the investors owned only 19 of the funds. Judge Arguello disagreed, ruling that the investors may only sue over the funds they actually own. "For all practical purposes, each fund in a series is a separate mutual fund. Plaintiffs may pursue claims only on behalf of funds in which they are invested," Judge Arguello stated.

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