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Fund and Investment Management

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Regulatory Update and Recent SEC Actions

REGULATORY UPDATES

Financial Industry Regulatory Authority ("FINRA") Releases Its 2019 Priorities

On January 22, 2019, FINRA released its Annual Risk Monitoring and Examination Priorities Letter, which highlighted the following five emerging areas of concern: (1) online distribution platforms; (2) regulatory technology; (3) compliance with FinCEN's Customer Due Diligence Rule; (4) fixed-income markup and markdown disclosure obligations; and (5) supervision of digital assets business. FINRA noted its concern that some member firms assert that they are not selling or recommending securities when involved with online distribution platforms despite evidence to the contrary, and FINRA vowed to assume heightened oversight and evaluation in this area. Additionally, FINRA plans to engage with firms to understand how they are using innovative regulatory technology tools and addressing related risks, challenges, or regulatory concerns. FINRA will assess firms' compliance with FinCEN's Customer Due Diligence Rule, which became effective in May 2018, focusing on the data integrity of suspicious activity monitoring systems as well as decisions associated with changes to those systems. FINRA also said it will review firms' compliance with fixed-income markup and markdown disclosure obligations and will look for any changes in firms' behavior that might be undertaken to avoid such disclosure obligations. Finally, firms are encouraged to notify FINRA if they plan to engage in activities related to digital assets (even if a membership application is not required) and FINRA will review firms' activities to assess their compliance with applicable securities laws and regulations.

FINRA Provides Guidance Regarding Inclusion of Pre-Inception Index Performance Data in Institutional Communications

On January 31, 2019, FINRA released an interpretive letter to Foreside Fund Services, LLC ("Foreside") establishing conditions under which it is permissible for broker-dealers to include pre-inception index performance ("PIP") data in communications concerning open-end investment companies that are distributed solely to institutional investors as defined by FINRA Rule 2210(a)(4). This is an expansion of the 2013 interpretive letter to ALPs Distributors, Inc., which provided similar guidance regarding the use of pre-inception performance data by the fund, but only as it applies to financial intermediaries. The Foreside letter allows the PIP data to be shared with institutional

clients so long as the communications—including that the PIP data—comply with several conditions and disclosure requirements that are listed in FINRA's letter. FINRA reiterated its longstanding position that PIP data cannot be used in communications with retail investors because it does not comply with FINRA Rule 2210(d).

The U.S. Securities and Exchange Commission ("SEC" or the "Commission") Proposes to Expand "Test-the-Waters" Modernization Reform to All Issuers

On February 19, 2019, the SEC voted to propose an expansion of a popular modernization reform that would permit investor views about potential offerings to be taken into account at an earlier stage in the process than current practices. The new rule and related amendments would expand the "test-the-waters" accommodation—currently available to emerging growth companies ("EGCs")—to all issuers, including investment company issuers. The proposal would allow all prospective issuers to gauge market interest by permitting discussions with certain investors prior to the filing of a registration statement. The proposed reform builds on a popular similar provision of the Jumpstart Our Business Startups ("JOBS") Act, which has been limited to EGCs. The proposed test-the-waters rule and related amendments are intended to provide increased flexibility to issuers with respect to their communications with institutional investors about contemplated registered securities offerings, as well as a cost-effective means for evaluating market interest before incurring the costs associated with such an offering. The comment period for the proposed rule ends on April 29, 2019.

"Extending the test-the-waters reform to a broader range of issuers is designed to enhance their ability to conduct successful public securities offerings and lower their cost of capital, and ultimately to provide investors with more opportunities to invest in public companies," said SEC Chairman Jay Clayton. "I have seen first-hand how the modernization reforms of the JOBS Act have helped companies and investors. The proposed rules would allow companies to more effectively consult with investors and better identify information that is important to them in advance of a public offering."

SEC Amends Submission Times for Form N-PORT

In response to data security concerns, on February 27, 2019, the SEC announced that it adjusted the submission deadlines for registered investment companies filing non-public monthly reports on Form N-PORT. A fund will now be required to file three monthly reports on Form N-PORT 60 days after the end of the fund's fiscal quarter. Previously, the fund was required to file the first two monthly reports of a quarter within 30 days after the end of each month. A fund's monthly reports on Form N-PORT for the first two months of the fiscal quarter will remain non-public and the monthly report for the third month will become publicly available upon filing. The adjustment in timing requirements for the filing of the monthly reports Form N-PORT was made to address cybersecurity concerns raised by the SEC's receipt of sensitive, non-public fund data on the form. Filing of Form N-PORT through the SEC's Electronic Data Gathering, Analysis, and Retrieval ("EDGAR") system began in April 2019 for larger fund groups and in April 2020 for smaller fund groups.

SEC Relaxes In-Person Voting Requirements for Boards in No-Action Letter

In a February 28, 2019 No-Action letter to the Independent Directors Council ("IDC"), the Staff of the SEC's Division of Investment Management (the "Division") expressed the position that boards are no longer required to meet in person for certain board actions under limited, specified circumstances. According to the No-Action letter, the Staff will not recommend enforcement actions for certain actions that would constitute violations of Sections 12(b), 15(c) or 32(a) of the Investment Company Act of 1940 or Rules 12b-1 or 15a-4(b)(2) thereof. The No-Action letter pertains to certain actions by a board, including its approval of an investment advisory contract or a 12b-1 plan and its selection of a fund's outside auditor. The IDC sought a no-action position that would allow directors to give these approvals telephonically, by video conference or by other means by which all participating directors communicate with each other simultaneously, in two types of circumstances. The first circumstance is when the directors needed for the approval cannot meet in person due to unforeseen or emergency circumstances, provided that (i) no material changes to the relevant contract, plan and/or arrangement are proposed to be approved, or are approved, at the meeting, and (ii) such directors ratify the applicable approval at the next in-person board meeting. The second circumstance is when the directors needed

for the approval previously fully discussed and considered all material aspects of the proposed matter during an in-person meeting, but did not vote on the matter at that time, provided that no director requests another in-person meeting. In issuing the No-Action letter, the Division agreed with the IDC that boards should be relieved of the requirement to meet in person in the circumstances set forth in the IDC's no-action request. When taking advantage of the relief afforded in this No-Action letter, boards should document (via minutes) the circumstances surrounding the inability to meet in person to ensure that the standards set forth in the No-Action letter are met.

"In light of market, regulatory, and technological developments, the Staff has continued to review existing director responsibilities and to consider whether they are appropriate and are carried out in a manner that serves the shareholders' best interests. We appreciate that, as you state in your letter, the position you are requesting from us would remove significant or unnecessary burdens for funds and their boards. We also do not believe the position would diminish the board's ability to carry out its oversight role or other specific duties."
— Erin Loomis Moore, Division Senior Counsel

Gabriel Benincasa Named SEC's First Chief Risk Officer
On February 28, 2019, the SEC announced that Gabriel Benincasa has been named the Commission's first Chief Risk Officer, a position created to strengthen the agency's risk management and cybersecurity efforts. In his new role, Mr. Benincasa will coordinate the SEC's continued efforts to identify, monitor, and mitigate key risks facing the Commission. Mr. Benincasa brings significant experience in senior leadership roles in risk and compliance in the financial sector. He began his legal career as an attorney at Davis Polk & Wardwell before working for numerous financial firms. He has served in roles, including Director of Enterprise Risk Management and Vice Chair of the Risk Control Committee for a financial services holding company; Deputy Global Head of Operational Risk Management for an investment bank; General Counsel and Chief Compliance Officer for an institutional asset management company; and Global Head of Compliance for a financial technology company.

"Establishing the Chief Risk Officer position at the SEC is an important step forward in our continuing efforts to strengthen the agency's risk management program," said Chairman Jay Clayton. "Gabe is an experienced senior leader with deep risk, legal, compliance, and financial markets expertise. I am certain we will benefit from his advice and insights."

Legislation Introduced to End Mandatory Arbitration in Adviser and Broker Contracts
On February 28, 2019, U.S. Sen. Sherrod Brown (D-OH), ranking member of the U.S. Senate Banking Committee, introduced the Arbitration Fairness for Consumers Act, a measure which would end pre-dispute arbitration agreements that are part of nearly every brokerage and investment-adviser contract. The legislation is primarily focused on student loans, credit card agreements, and employment contracts, but the bill would also apply to the arbitration system for broker-customer disputes run by FINRA, as well as to the American Arbitration Association system used by most investment adviser clients. According to the press release issued by Sen. Brown when introducing the bill, it is supported by several consumer groups. The arbitration legislation will face a challenging landscape as it proceeds on Capitol Hill, where Democrats control the House and Republicans hold the majority in the Senate.

Maryland Joins Other States in Pursuing Fiduciary Regulations
Maryland has joined other states, including Nevada, New Jersey, and Washington, in introducing fiduciary regulations. In early February 2019, the Financial Consumer Protection Act of 2019 was introduced in Maryland's House and Senate Chambers. The act would deem both brokers and insurance agents fiduciaries with a duty to act in the best interest of the customer without regard to the financial or other interest of the person or firm providing the advice. As with other state proposals, Maryland's proposal would create a blanket fiduciary rule for all advisors.

The Securities Industry and Financial Markets Association ("SIFMA") Argues against State Fiduciary Regulations

SIFMA recently reiterated its opposition to state fiduciary initiatives, explaining that it believes the SEC's proposed Regulation Best Interest ("Regulation BI") will preempt state action in this area, arguing that Regulation BI should be a substitute for, and not an addition to, any state fiduciary standard. In arguing that Regulation BI would preempt state fiduciary laws, SIFMA relies on the National Securities Markets Improvements Act, a 1996 law that delegated the authority to regulate the U.S. securities industry to federal agencies, which forced states to conform their financial regulations and recordkeeping requirements to the Securities Exchange Act of 1934 and other federal laws. SIFMA's position is that states have no authority to enact rules that require financial professionals to keep more records than federal law mandates. SIFMA spokeswoman Lindsay Gilbride stated, "To the extent a state passes a statute or regulation that includes or requires a books & records requirement that is new or different than [Regulation] BI (or other books and records requirements under the Exchange Act and FINRA Rules), it is preempted."

SEC Commissioner Advises States to Wait for Finalization of Regulation BI Before Moving Ahead with State Fiduciary Regulations

On March 7, 2019, SEC Commissioner Hester Peirce said that states should wait until the SEC's Regulation BI is finalized before they move ahead with their own best-interest rules. "I do think it would be helpful to have a common [best interest] standard," Ms. Peirce stated during a Q&A session at the IAWatch compliance conference in Washington, D.C. She urged the industry to take a close look at the standards set forth in Regulation BI and said the states' continued input in the process of finalizing Regulation BI is important to the SEC.

XBRL Taxonomy Update

The SEC announced on March 11, 2019, that its EDGAR system was upgraded to Release 19.1 and now supports the 2019 U.S. GAAP, 2019 SEC Reporting (SRT), 2019 Currencies (Currency), and 2019 Exchanges (EXCH) taxonomies. The 2019 U.S. GAAP financial reporting taxonomy and the 2019 SEC Reporting Taxonomy reflect the same taxonomies that the Financial Accounting Standards Board made available on its website on December 18, 2018. The 2019 Currency and 2019 EXCH taxonomies reflect the same taxonomies the staff posted for public comment on November 30, 2018. Details of the changes can be found on the SEC's website (xbrl.sec.gov/doc/releasenotes-2019.pdf). The Staff of the SEC does not anticipate that the removals of the 2017 U.S. GAAP, 2016 Currency, or 2017 EXCH taxonomies will occur before June 2019. The Staff strongly encourages companies to use the most recent version of taxonomy releases for their XBRL exhibits to take advantage of the most up-to-date tags related to new accounting standards and other improvements. The Staff suggests that filers consider transitioning to the 2019 taxonomies for the earliest reporting period which ended *after* March 11, 2019, but not for reporting periods that ended *before* March 11, 2019.

SEC Calls for More Robust Brexit Disclosures

On March 15, 2019, SEC Director of Corporate Finance William Hinman spoke in London at the 18th Annual Institute on Securities Regulation in Europe. Mr. Hinman said that the Commission has evaluated the quality of disclosures relating to Britain's impending departure from the European Union and discovered a disparity in the Brexit-related risk factors. He noted that there is "tremendous uncertainty" surrounding Brexit, including whether it will be delayed past the initial deadline, as well as what effects it will have on companies across different industries. To discern what risks should be disclosed, Director Hinman encouraged companies to query whether disclosures would satisfy the curiosity of a board member considering the impact of Brexit on a company's business, operations and strategic plans. The SEC expects that disclosures will address regulatory risks a company may face as a result of transition, potential impact on supply chain, risk of customer loss, exposure to currency devaluation, foreign currency exchange rate risk or other market risks, uncertainties regarding existing contracts, and whether or not Brexit might affect financial statement recognition, measurement, or disclosure items.

Investment Management Director Highlights 2019 Initiatives; Focus on Competition among Asset Managers

On March 18, 2019, the SEC's Investment Management Division Director Dalia Blass spoke at the Investment Company Institute ("ICI") Mutual Funds and Investment Management Conference in San Diego, California. Director Blass highlighted the Division's 2019 initiatives, which are a

continuation of those from 2018, along with new initiatives addressing proxy advisors, international policy and asset management. The initiatives will be further developed in 2019 to improve the investor experience in the financial markets. Director Blass noted that the 2019 initiatives include (1) business development company and closed-end fund offering reform; (2) proposing rules around an investment company's derivatives use; (3) investment adviser advertising and solicitation rule modernization; (4) reviewing the relevancy of prior Staff statements in light of current market developments; and (5) improving the exemption application process to streamline routine exemption requests, allowing the Division to focus on more complex requests. Director Blass also noted that the SEC will examine whether investors' choice of asset management companies will be damaged by competitive pressures that threaten to eliminate smaller asset management companies. She said, "I am concerned about what it will mean for investors, particularly main street investors, if the variety and choice offered by small and midsized asset managers becomes lost in a wave of consolidation and fee compression." She went on to state that the SEC may establish an advisory committee to examine asset management issues, including the effect of indexing on markets, common ownership, the consequences of the scale of investment management companies, and the participation of funds in markets historically associated with banks and brokers.

SEC Adopts Rules to Modernize and Simplify Disclosure

On March 20, 2019, the SEC voted to adopt amendments that modernize and simplify disclosure requirements for public companies, investment advisers, and investment companies. The amendments, consistent with the Commission's mandate under the Fixing America's Surface Transportation ("FAST") Act, are based on recommendations in the Staff's FAST Act Report as well as a broader review of the Commission's disclosure rules. These amendments are expected to benefit investors by eliminating what some viewed as outdated and unnecessary disclosure requirements, making it easier for investors to access and analyze material information. The amendments are intended to improve the readability and navigability of company disclosures, and to discourage repetition and disclosure of immaterial information. Among other things, the amendments will increase flexibility in the discussion of historical periods in the Management's Discussion and Analysis financial section, allow companies to redact confidential information from most exhibits without filing a confidential treatment request, eliminate the risk factor examples listed in the disclosure requirement, revise the description of property requirement to emphasize the materiality threshold, and incorporate technology to improve access to information on the cover page of certain filings. Most of the amendments will be effective 30 days after they are published in the Federal Register, except that the amendments relating to the redaction of confidential information in certain exhibits will become effective upon publication in the Federal Register.

SEC Proposes Offering Reforms for Business Development Companies and Registered Closed-End Funds

On March 20, 2019, the SEC voted to propose rule amendments that would improve access to capital and facilitate investor communications by business development companies ("BDCs") and registered closed-end funds. BDCs are closed-end funds established by Congress that primarily invest in small and developing companies. The proposed amendments would modify the registration, communications, and offering processes available to BDCs and registered closed-end funds, building on offering practices that operating companies currently use. Eligible funds would be allowed to engage in a more streamlined registration process to sell securities and allow BDCs and registered closed-end funds to use communications and prospectus delivery rules currently available to operating companies. The proposal includes additional amendments designed to help implement the Congressionally-mandated amendments by further harmonizing the disclosure and regulatory framework for these funds with that of operating companies and by providing tools to help investors assess these funds and their offerings. These proposed amendments also include new periodic and current reporting requirements and new structured data requirements. The Commission is also proposing a modernized approach to registration fee payments for closed-end funds that operate as "interval funds." The proposal will have a 60-day public comment period following its publication in the Federal Register.

Allison Lee Nominated to Be Second Democratic Commissioner of the SEC

On April 2, 2019, President Trump announced he would nominate veteran finance lawyer Allison Lee to be the second Democratic Commissioner of the SEC. Ms. Lee has more than two decades of experience in securities law and served in several top roles at the SEC between 2005 and 2018. She was previously counsel to former SEC Commissioner Kara Stein, who Ms. Lee was nominated to replace, and senior counsel of the Commission's Complex Financial Instruments Unit. Ms. Lee is also a former special assistant U.S. attorney and partner at Denver law firm Sherman & Howard.

ENFORCEMENT ACTIONS

***SEC v. Goldsky Asset Management, LLC and Kenneth Grace* (Case No. 18-8870, S.D.N.Y.)**

On January 2, 2019, the S.D.N.Y. entered final consent judgments against Goldsky Asset Management, LLC, ("Goldsky") and its owner, Kenneth Grace, for making false and misleading statements about its business in filings with the Commission and on Goldsky's website.

The complaint, filed September 17, 2018, alleged that Goldsky's Forms ADV for 2016 and 2017, which Grace signed, falsely stated that Goldsky's hedge fund had an auditor, a prime broker and custodian, and an administrator. The complaint further alleges that in its Forms ADV and ADV Part 2A, Goldsky stated that it managed over $100 million in discretionary assets under management, when it in fact had no assets. The complaint also alleges that Goldsky's website misrepresented its hedge fund's earnings.

Goldsky and Grace consented to the entry of final judgments enjoining them from violating the antifraud provisions of Sections 206(4) and 207 of the Investment Advisers Act of 1940 and Rule 206(4)-8 thereunder, and ordering Goldsky and Grace to pay civil monetary penalties of $50,000 and $25,000, respectively.

***SEC v. Daniel H. Glick, et al.* (Case No. 17-2251, N.D. Ill.)**

On January 4, 2019, the District Court for the Northern District of Illinois entered a final judgment by default against defendant Edward H. Forte in an SEC enforcement action. The action relates to charges brought against Daniel H. Glick, a Chicago-based investment adviser, and his unregistered investment advisory firm, Financial Management Strategies Inc. ("FMS"), for misappropriating millions of dollars from elderly investors. The complaint named Forte as a defendant, alleging that he received more than one million dollars of the money that had been misappropriated by Glick.

The final judgment against Forte orders him to pay disgorgement of $1,013,637, representing money he received as a result of Glick's and FMS' violation alleged in the complaint along with prejudgment interest of $30,633 for a total of $1,044,270.

***SEC v. Alexander C. Burns, et al.* (Case No. 18-90477, S.D.N.Y.)**

On January 11, 2019, the District Court for the Southern District of New York entered a judgment against Andrew B. Scherr, the co-owner of Southport Lane Management, LLC ("Southport Lane"), a now-defunct private equity firm. The SEC charged Scherr with aiding and abetting a fraud perpetrated by Southport Lane's majority owner, Alexander C. Burns. The SEC's complaint alleges that Scherr acquired assets for Southport Lane that were worthless or overvalued and knew or should have known that Burns intended to and did sell the overvalued assets to the clients of Southport Lane Advisors, LLC. Without admitting or denying the allegations in the SEC's complaint, Scherr consented to the entry of a judgment enjoining him from violating the antifraud provisions of Sections 206(1) and (2) of the Investment Advisers Act of 1940. Potential disgorgement and civil monetary penalties will be assessed by the court at a later date.

***SEC v. Oleksandr Leremenko, et al.* (Case No. 19-505, D.N.J.); SEC Brings Charges in EDGAR Hacking Case**

In a January 15, 2019 press release, the SEC announced that it charged nine defendants for participating in a previously disclosed scheme to hack into the SEC's EDGAR system and extract non-public information to use for illegal trading. The SEC charged a Ukrainian hacker named Oleksandr Leremenko; six individual traders in California, Ukraine, and Russia; and two entities. The SEC's complaint alleges that Leremenko gained access to EDGAR in 2016 by using deceptive hacking techniques. Leremenko extracted EDGAR test files containing non-public earnings results. The information was passed to individuals who used it to trade in the narrow window between when the files were extracted from the SEC system and when the companies released the

information to the public. In total, the defendants traded before at least 157 earnings releases from May to October 2016 and generated at least $4.1 million in illegal profits. The SEC's complaint charges each of the defendants with violating the federal securities antifraud laws and related SEC antifraud rules and seeks a final judgment ordering the defendants to pay penalties, return their ill-gotten gains with prejudgment interest, and enjoining them from committing future violations of the antifraud laws.

"International computer hacking schemes like the one we charged today pose an ever-present risk to organizations that possess valuable information," said Enforcement Division Co-Director Stephanie Avakian. "Today's action shows the SEC's commitment and ability to unravel these schemes and identify the perpetrators even when they operate from outside our borders."

SEC v. Thomas Conrad, Jr. et al.
(Case No. 16-2572, N.D. Ga.)
On January 17, 2019, a District Court in the Northern District of Georgia granted in part and denied in part the SEC's motion for partial summary judgment against Thomas Conrad, Jr., and two unregistered advisory firms he controlled, Financial Management Corporation ("FMC") and Financial Management Corporation, S.R.L. ("FMC Uruguay"). The complaint, filed July 15, 2016, alleges that Conrad directed preferential redemptions and other disbursements from funds advised by FMC and FMC Uruguay for himself, his extended family, and certain favored investors, while representing to other investors that redemptions were suspended. The complaint also alleges that Conrad failed to disclose conflicts of interest arising from loans made to Conrad's family members and Conrad's appointment of himself as a sub-manager for a fee. The complaint further alleges that, in offering materials given to prospective investors, defendants touted Conrad's significant experience in the securities industry but failed to disclose his disciplinary history.

The court ruled that the SEC was entitled to summary judgment on its fraud claims based on the fraudulent redemption practices and failure to disclose Conrad's disciplinary history. The court denied the SEC's motion for summary judgment on its claims that Conrad failed to disclose conflicts of interest, finding that there were disputed issues of facts.

SEC v. Joseph A. Meyer, Jr. and Statim Holdings, Inc.
(Case No. 18-5868, N.D. Ga.)
On January 28, 2019, the SEC charged an investment adviser and an entity he controls with defrauding a private fund they managed and its investors. The complaint alleges that Joseph A. Meyer, Jr., and Statim Holdings, Inc. offered and sold four classes of limited partnership interests in Arjun, L.P., a private fund. Meyer promised investors that, in return for giving up substantial portions of their profits, investors in one class would be protected from loss ("No Loss Protection Class"), and investors in two other classes would receive guaranteed fixed returns. According to the complaint, rather than use the relinquished profits to fund the No Loss Protection Class and guaranteed returns, Meyer withdrew most of the relinquished profits and used the funds to pay his living expenses. To deceive investors, Meyer allegedly recorded on Arjun's books a receivable due from Statim. The complaint alleges that Meyer claimed to pay down Statim's receivable, but did so by directly or indirectly borrowing money from the fund, therefore making the guarantees and No Loss Protection Class illusory because they were backed by nothing other than the receivable.

The complaint alleges that this activity violated the antifraud provisions of Section 17(a) of the 1933 Act, Section 10(b) and Rule 10b-5 of the 1934 Act, and Sections 206(1), (2), and (4) of the Investment Advisers Act, and that Meyer aided and abetted Statim's violations of these provisions.

In the Matter of Deloitte Touche Tohmatsu LLC, Futomichi Amano, and Yuji Itagaki
(SEC File No. 3-18997)
On February 13, 2019, the SEC announced that Deloitte Japan will pay two million dollars to settle charges that it issued audit reports for an audit client at a time when dozens of its employees maintained bank accounts with the client's subsidiary. According to the order, the accounts had balances that exceeded depositary insurance limits in violation of the SEC audit independence rules; under the SEC audit, accountants are not considered to be independent if they maintain bank accounts with an audit client with balances greater than FDIC or similar depositary insurance limits.

Futomichi Amano, Deloitte Japan's former CEO, and Yuji Itagaki, Deloitte Japan's former reputation and risk leader and director of independence, were also charged. According to the complaint, Amano and Itagaki caused the audit client to violate its reporting obligations and engaged in improper professional conduct within the meaning of Rule 102(e) of the SEC's Rules of Practice. Amano was one of 89 Deloitte Japan employees who maintained a bank account with the client's subsidiary. Amano and Itagaki agreed to be suspended from appearing and practicing before the SEC as accountants, which includes not participating in the financial reporting or audits of public companies. The SEC's order allows Amano and Itagaki to apply for reinstatement after two years and one year, respectively.

***In the Matter of Brian Hirsch* (No. 17-cv-13226, D.N.J.)**
On February 13, 2019, the District Court for the District of New Jersey entered a final judgment against defendant Brian Hirsch, who was charged by the SEC in connection with public offering allocation practices at two larger brokerage firms. The SEC filed a complaint on December 19, 2017, alleging that Hirsch, while associated with dually registered broker-dealers and investment advisers, entered into undisclosed arrangements with certain customers to provide the customers with preferential access to, and larger allocations of, public offerings marketed by the firms. In return, these customers made cash payments to Hirsch of up to 25 percent of the profits made by selling the offering stock in the secondary market. The final judgment, to which Hirsch consented, enjoins him from violating the antifraud provisions of Section 10(b) of the 1934 Act and Rule 10b-5 thereunder and imposes a total penalty of $783,000 in disgorgement plus prejudgment interest.

Hirsch previously pled guilty to criminal charges filed in a parallel action by the U.S. Attorney's Office for the District of New Jersey. The $783,000 disgorgement from the SEC order was deemed satisfied by $800,000 in forfeiture that was ordered in the criminal proceeding.

SEC v. Castleberry Financial Services Group, LLC, et al.
(Case No. 19-80244, S.D. Fla.)
On February 20, 2019, the SEC filed an emergency action against Castleberry Financial Services Group, LLC, President T. Jonathon Turner, and CEO Norman M. Strell, alleging that in the past year they have defrauded investors out of $3.6 million. According to the complaint, Castleberry falsely represented to investors that it had hundreds of millions of dollars in capital invested in local businesses and a portfolio of hundreds of investment properties. Castleberry claimed to offer high yields while protecting investors' principal by having it "fully insured and bonded" by CAN Financial Corp. and Chubb Group, when in fact the insurance companies had no relationship with Castleberry and did not authorize it to use their logos in Castleberry's sales materials.

The complaint also alleges that Turner and Strell diverted and misappropriated investor funds to pay personal expenses and transferred other funds to businesses they control and to family members. The SEC also alleges that Castleberry's website and promotional materials falsely represented that Turner has extensive finance industry experience, an MBA degree, and a law degree, while concealing that Turner was previously convicted of multiple fraud, theft, and forgery felonies and was imprisoned from 1998 until 2016.

The Court in the Southern District of Florida granted the SEC's request for a temporary restraining order and temporary asset freeze against the defendants, and issued an order directing the defendants to provide a sworn accounting.

SEC v. James S. Polese, et al.
(Case No 18-10186, D. Mass.)
On February 22, 2019, the SEC announced the entry of final judgment against James S. Polese, a former investment adviser charged with misappropriating client funds.
The complaint charged Polese and his former colleague Cornelius Peterson with securities fraud for engaging in various schemes to defraud their clients, including fraudulently misappropriating $350,000 of one client's money for personal use, and investing $100,000 of another client's funds into an investment in which Peterson and Polese held a financial interest, without informing the client or disclosing their conflict of interest.

The final judgment against Polese, to which Polese consented, disgorges $307,300 in ill-gotten gains plus prejudgment interest of $35,276. The order also enjoins Polese from violating the antifraud provisions of Section 10(b) and Rule 10b-5 of the 1934 Act, and Section 206(1) and (2) of the Investment Advisers Act, as well as aiding and abetting any investment adviser's violations of the books

and records provisions of Section 204 and 204(2) of the Investment Advisers Act. The SEC has also entered an order barring Polese from associating with any broker, dealer, investment adviser, municipal securities dealer, municipal adviser, transfer agent, or nationally-recognized statistical rating organization, and from participating in any offering of penny stock.

***In the Matter of BB&T Securities, LLC, as successor-in-interest to Valley Forge Asset Management, LLC* (SEC File No. 3-19020)**

On March 5, 2019, the SEC announced that BB&T Securities had agreed to return more than five million dollars to retail investors and pay a $500,000 penalty to settle charges that a firm it acquired, Valley Forge Asset Management, LLC ("Valley Forge") willfully violated Section 206(2) and Section 207 of the Advisers Act of 1940. The SEC order alleges that from at least 2013 to 2016, Valley Forge made misleading statements in its Forms ADV Part 2A and investment advisory contracts with clients regarding the services and prices offered by its in-house broker that led numerous clients to choose Valley Forge for brokerage services over other significantly less expensive options. Valley Forge was allegedly paid more than $4.7 million in excess compensation by advisory clients during the period at issue. BB&T Securities consented to the order without admitting or denying its findings.

SEC's Self-Report Project Nabs $125M in Deals with 79 Firms

On March 11, 2019, the SEC announced it settled charges against 79 investment advisers who agreed to repay more than $125 million to clients, with a substantial portion of the funds going to retail investors. The investment advisers will avoid additional fines because they self-reported their conduct under the SEC's Share Class Selection Disclosure Initiative announced in February 2018 (the "Initiative"). The Initiative incentivized investment advisers to (i) self-report violations of the Investment Advisers Act of 1940 (the "Advisers Act") resulting from undisclosed conflicts of interest, (ii) promptly compensate investors, and (iii) review and correct fee disclosures. According to the SEC, the settling investment advisers recommended mutual fund share classes with recurring fees over lower-cost options creating conflicts of interest since the investment advisers benefitted from the fees. The SEC found that the advisers did not adequately disclose these conflicts of interest to their clients in violation of the Advisers Act. Without admitting or denying the findings, the investment advisers consented to cease-and-desist orders and agreed to a censure and to disgorge the improperly disclosed fees. They also agreed to review and correct all relevant disclosure documents. Consistent with the terms of the Initiative, the SEC has agreed to not impose penalties against the investment advisers.

"Regardless of the scope and duration of the investment advisory services, investment advisers are fiduciaries and, as such, their duties of care and loyalty require them to disclose their conflicts of interest, including financial incentives. I am pleased that so many investment advisers chose to participate in this initiative and, more importantly, that their clients will be reimbursed." — SEC Chairman Jay Clayton

***In the Matter of Grant Gardner Rogers* (SEC File No. 3-19107); *In the Matter of Talimco, LLC* (SEC File No. 3-19108)**

On March 15, 2019, the SEC charged Grant Gardner Rogers, the former COO of Talimco LLC ("Talimco"), a registered investment adviser, and Talimco with manipulating the auction of a commercial real estate asset on behalf of one client for the benefit of another. According to the SEC's order, Talimco and Rogers were representing a collateralized debt obligation client in the auction sale of a commercial real estate asset. Rather than seek multiple bona fide bidders, the order finds that Rogers used the firm's affiliated private fund client for one bid and convinced two unwilling bidders to participate in the auction by giving assurances that the bidders would not win the auction. As a result of manipulating the auction, Talimco's private fund client was the highest bidder and acquired the asset, only to later sell it for a substantial profit. This deprived the selling client of the opportunity to obtain multiple bona fide bids for the asset and maximize its profit.

The settled orders find that Talimco and Rogers violated Section 206(2) of the Investment Advisers Act. Talimco consented to a cease-and-desist order, a censure, disgorgement of its fees of $74,000 plus prejudgment interest of $8,758.00, and a penalty of $325,000. Rogers consented to a cease-and-desist order, a 12-month industry suspension, and a $65,000 fine.

SEC v. Carol Ann Pedersen **(Case No. 19-2069, C.D. Cal.)**
On March 20, 2019, the SEC charged Carol Ann Pedersen, a former CPA and unregistered investment adviser, with stealing millions of dollars from investors to perpetrate a Ponzi scheme. The SEC alleges that Pedersen raised at least $29 million from 25 investors, falsely promising to invest their money in securities. According to the complaint, rather than make the promised investments, Pedersen used about $25.6 million to make Ponzi-style payments to investors, and the remaining funds to pay for personal expenses. In order to conceal the fraudulent scheme, the complaint further alleges that Pedersen provided investors with fabricated account statements that falsely represented that investors' money had been invested and was earning a return.

The SEC's complaint charges Pedersen with violating the antifraud provisions of Section 17(a) of the 1933 Act, Section 10(b) and Rule 10b-5 of the 1934 Act, and Sections 206(1), (2), and (4) of the Investment Advisers Act, and Rule 206(4)-8 thereunder. Pedersen has agreed to the entry of final judgment in which she consents to injunctive relief and to be liable for approximately $2.7 million in disgorgement and interest. On the same day the SEC filed its complaint, the U.S. Attorney's Office for the C.D. Cal. announced criminal charges arising from the same conduct.

EMERGING TECHNOLOGY TRENDS

In this new section of our Regulatory Update, we discuss the latest developments for registered investment companies and investment advisers to consider in connection with potential use cases and strategies of blockchain technology and cryptocurrencies.

SEC Seeks Input Regarding Blockchain Role in Asset-Custody Regulations
In a public letter sent to the Investment Adviser Association ("IAA") on March 14, 2019, the SEC sought input regarding whether blockchain can help investment advisers track client assets and whether such advisers consider tokens and cryptocurrencies to be securities or funds, incorporating new technology into the agency's evaluation of asset-custody regulations. The SEC asked advisers how regulations are being applied in the digital arena, what unique risks are associated with the custody of digital assets, and how the transaction process works. The SEC also asked to what extent distributed ledger or decentralized technology, such as blockchain, could enhance or diminish client protection when settling transactions involving assets other than securities, such as funds, swaps, and bank loans. The IAA has been working with SEC Staff to elucidate scenarios in which the agency deems advisers to have taken custody of digital assets, a designation which not only comes with additional compliance expectations but also has raised concerns for the IAA. The IAA plans to detail those and other concerns in its response to the SEC.

Cryptocurrency Futures
Intercontinental Exchange ("ICE"), owner of the N.Y.S.E., is planning to launch the first futures contract that would pay out in bitcoin. The launch of Bakkt, ICE's name for the project, has been delayed due to a lack of Commodity Futures Trading Commission ("CFTC") approval.

In February 2019 the CFTC told ICE that Bakkt's plan to store customers' bitcoins would require disclosures of the venture's business plan and a public comment period, which would further delay approval of the project. ICE and the CFTC are discussing alternative ways for Bakkt to custody customer funds to mitigate any further delays.

SEC Approval of Cryptocurrency Exchange-Traded Fund ("ETF")
Currently, the SEC has not approved any proposals for a cryptocurrency ETF. Despite the recent slew of rejections, Robert J. Jackson Jr., a Commissioner at the SEC, indicated that a cryptocurrency ETF will likely be approved at some point in time.

Guidance on Investment Contract Analysis of Digital Assets and No-Action Letter
On April 3, 2019, the SEC released Staff Guidance titled "Framework for 'Investment Contract' Analysis of Digital Assets," which applies the factors set forth in *SEC v. W.J. Howey Co.,* 328 U.S. 293 (1946), to determine whether a digital asset that is offered and sold is an investment contract under the federal securities laws. The factors set forth in *Howey* (the "*Howey* Test") are: 1) an investment of money, 2) an expectation of profits from the investment, 3) whether the investment of money is in a common enterprise, and 4) whether any of the profits arise from the efforts of a promoter or third party. The Staff Guidance is

non-binding and does not alter the requirements established in *Howey* or other related securities law analysis in existing court decisions, but it does provide insight into how the SEC intends to apply the Howey Test to digital assets and when the SEC may determine to pursue possible violations of the securities laws.

The Staff Guidance, for the first time, provides a roadmap for utility tokens, focusing on whether the digital asset purchaser has a reasonable expectation of profits derived from the efforts of others. This analysis is objective, "focused on the transaction itself and the manner in which the digital asset is offered and sold." In determining whether a digital asset purchaser relies on the efforts of others, namely "Active Participants" (promoters, sponsors, or other parties who traditionally participate in the offer and sale of securities), the Staff analyzed two key issues:

- Does the purchaser reasonably expect to rely on the efforts of an Active Participant; and
- Are those efforts the "undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."

The Staff Guidance focuses on a number of elements that will influence the determination, including:

- whether the Active Participant is responsible for the network, including whether the network or the digital asset is fully functional at the time of the offer or sale;
- whether essential tasks or responsibilities will be performed by an Active Participant rather than unaffiliated users who are spread around the globe;
- whether an Active Participant creates or supports a market or the price of the digital asset, including controlling the creation and issuance of the digital asset;
- whether an Active Participant has a lead or central role in the direction of the ongoing development and governance of the network in which the digital asset is created;
- whether an Active Participant has a continuing managerial role regarding the network or the characteristics of the digital asset; and
- whether purchasers reasonably expect the Active Participant to undertake efforts to promote its interests and enhance the value of the network or digital assets.

The core focus is whether an Active Participant provides essential managerial efforts that affect the success of the enterprise. As such, the less control the Active Participants have, the less likely the SEC is to find that the purchaser was relying on the efforts of others. With respect to whether a digital asset purchaser has a reasonable expectation of profits, the Staff looked at:

- whether the digital asset gives the holder a share in the enterprise's income or profits;
- whether the digital asset is transferable (including whether it is or may be traded on a secondary market or platform);
- whether purchasers would reasonably expect that an Active Participant's efforts would result in capital appreciation;
- whether the digital asset was offered to any potential purchaser or more narrowly targeted only to users of the goods or services associated with the digital asset;
- correlation between the offering or purchase price and the price of the goods or services to be acquired in exchange for the digital asset;
- correlation between typical quantities of digital assets traded and the amount of underlying goods or services a typical consumer would purchase for use or consumption;
- whether proceeds from the offering exceed what may be needed to create and maintain the functional network for the digital asset;
- whether the Active Participant benefits from its efforts as a result of holding the same class of digital assets;
- whether the Active Participant continues to expend funds from the proceeds to enhance the functionality or value of the network or digital asset; and
- whether there are any other relevant elements of the marketing of the digital asset that support a profit intent.

The Staff also disclosed that it will consider other factors that inform the economic reality of the transactions, such as whether the network for the digital asset is functional at launch, whether the digital asset can be used immediately to transfer value to another holder, and whether the Active Participants promote secondary market trading of the digital asset are other factors in making the determination of whether a digital asset is a security. This Staff Guidance provides additional analytical details as to how the SEC will view token offerings and where key distinctions should be made in determining whether digital asset sales fall outside of the Howey Test analysis regarding the reasonable expectation of profits derived from the efforts of others, thus providing a clear indication that certain utility tokens can be issued without fear of making an unregistered distribution of securities.

Also on April 3, 2019, the SEC issued a No-Action Letter regarding TurnKey Jet, Inc. ("TurnKey") related to its digital asset offering. TurnKey is an interstate air charter service provider that plans to use digital tokens to facilitate air travel transactions. In the No-Action Letter, the Staff of the Division of Corporation Finance of the SEC said it would not recommend an enforcement action to the Commission if, in reliance on a token issuer's opinion as counsel that the tokens to be distributed were not securities, the token issuer offers and sells the tokens without registration under the Securities Act and the Exchange Act because (1) funds from the digital asset sales would not be used to develop TurnKey's blockchain platform, network, or app; (2) tokens would be immediately useable upon purchase; (3) tokens would only be tradeable in the TurnKey wallet and not across external platforms; (4) the token value would be maintained at one U.S. dollar and can only be resold to TurnKey at a discount to its face value; and (5) TurnKey's marketing material focuses on the functionality of the token rather than the token's potential increase in market value. Accordingly, this No-Action Letter gives helpful insight into when the Staff will not recommend enforcement action in connection with an unregistered digital asset sale.

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