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## Regulatory Update and Recent SEC Actions

### REGULATORY UPDATES

#### Allison Herren Lee Sworn in as Commissioner

On July 8, 2019, Allison Herren Lee was sworn into office as a Securities and Exchange Commission (“SEC”) Commissioner. Lee was nominated to the SEC by President Donald J. Trump and unanimously confirmed by the United States Senate. Commissioner Lee has more than two decades of experience as a securities law practitioner. Most recently, she has written, lectured, and taught courses internationally on financial regulation and corporate law. She served for more than a decade in various roles at the SEC, including as counsel to Commissioner Kara Stein, and as senior counsel in the Division of Enforcement’s Complex Financial Instruments Unit. Commissioner Lee fills a term that expires on June 5, 2022.

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*“Allison’s expertise in securities law, including from her prior tenure at the Commission, will be invaluable to our efforts to advance the interests of investors and our markets,” said Chairman Jay Clayton. “Many of Allison’s former—and as of Monday, current—colleagues have expressed to me their support for Allison’s return. On behalf of all of my colleagues, commissioners, and staff alike, I am pleased to welcome her back.”*

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#### House Bills Would Boost SEC Penalties and Increase Time to Impose Penalties

On July 16, 2019, the [House] Financial Services Committee approved bills that would give the SEC more time to impose civil penalties and increase the size of penalties. Both bills were referred to the House of Representatives for further action, but a full House vote has not been taken on either one. H.R. 3701 would increase to 10 years the current five-year statute of limitations on when the SEC can impose civil penalties. The bill would overturn a 2013 U.S. Supreme Court ruling in *Gabelli vs. SEC* that the five-year clock begins when the violation occurs, rather than when the SEC discovered it. H.R. 3641 provides for higher statutory limits on SEC civil monetary penalties and a link between the size of the penalty and the scope of harm and investor losses. Caps on fines for individuals would increase to one million dollars per violation from \$181,071, and those for entities would rise to \$10 million per violation, from \$905,353. The SEC would also be able to assess the penalties through administrative actions as well as in federal court.

## **FINRA Announces Final Results of Mutual Fund Waiver Initiative**

On July 17, 2019, the Financial Industry Regulatory Authority (“FINRA”) announced that it settled with 56 member firms and obtained a total of \$89 million in restitution for nearly 110,000 charitable and retirement accounts as a result of its mutual fund fee waiver initiative. All of the firms failed to waive mutual fund sales charges for the eligible accounts and failed to reasonably supervise the sale of mutual funds offering sales charge waivers. Of the 56 firms sanctioned, 43 were granted extraordinary cooperation and not fined.

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*“This was a multi-year effort with the goal of obtaining meaningful restitution for mutual fund investors who were not afforded the sales charge waivers they were entitled to,” said Susan Schroeder, FINRA Executive Vice President, Department of Enforcement. “Ensuring that harmed customers are made whole is our highest priority and, in some instances, FINRA granted credit for extraordinary cooperation to those firms who were proactive in identifying and fixing the issue, and who quickly remediated affected customers.”*

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## **Office of Compliance Inspections and Examinations (“OCIE”) Issues Risk Alert Related to Employment of Individuals with Disciplinary Histories**

On July 23, 2019, the OCIE issued a risk alert concerning the oversight practices of SEC-registered investment advisers that previously employed, or currently employ, any individual with a history of disciplinary events. After conducting more than 50 examinations of advisers, the OCIE observed several deficiencies related to compliance. The risk alert outlined how firms can improve compliance when they employ supervised persons with disciplinary histories. The OCIE recommends, among other things, that advisers (i) adopt written policies and procedures that specifically address what must occur prior to hiring supervised persons that have reported disciplinary events; (ii) enhance due diligence practices associated with hiring supervised persons to identify disciplinary events (background checks, requests for Form U5s); (iii) establish heightened supervision practices when overseeing supervised persons with certain disciplinary histories; (iv) adopt written policies and procedures addressing client complaints related to supervised persons; and (v) ensure that compliance and supervisory programs include oversight of persons operating out of remote

offices. The OCIE encouraged advisers, when designing and implementing their compliance and supervision frameworks, to consider the risks presented, as well as the disclosure requirements triggered, by the hiring and employing of supervised persons with disciplinary histories and adopt policies and procedures to address those risks and disclosure requirements.

## **Robert A. Cohen Leaves SEC**

On July 29, 2019, the SEC announced that Robert A. Cohen, Chief of the Division of Enforcement’s Cyber Unit, would leave the agency in August 2019 after 15 years of service. Cohen is the first chief of the Cyber Unit, created in 2017. The unit focuses on violations involving digital assets and cryptocurrency, cyber-related trading violations, such as hacking to obtain material nonpublic information, and cybersecurity disclosures and procedures at public companies and financial institutions. Previously, Cohen was co-chief of the SEC’s Market Abuse Unit.

## **SEC Steps Up Scrutiny of Private Stakes Held by Mutual Funds**

Insiders have indicated that the SEC is stepping up scrutiny of mutual fund investments in private companies. When mutual funds invest in private companies the valuation they give these private shares can vary wildly from fund to fund and the stakes can be hard to sell. In some cases, individual investors in the fund may not even know that their cash has been invested in private companies. SEC officials, including those in the SEC’s Division of Investment Management, have talked to asset managers and others in recent months about whether additional disclosures or other steps to protect retail investors are needed, say the insiders. It is unclear if the SEC is planning policy changes or just surveying market opinion.

## **New York Lawmaker Works on Bill to Establish Fiduciary Duty for Advisers in State**

In July 2019, New York State Assemblyman Jeffrey Dinowitz, D-Bronx, announced that he is crafting a bill that would impose a fiduciary standard on all advisers in New York. He hopes to introduce it at the beginning of the next legislative session in January. According to Dinowitz, the SEC’s Regulation Best Interest (“Regulation BI”) did not go far enough to protect consumers’ interests. “This would be a stronger bill because advisers are not required to act in a consumer’s best interest,” said Dinowitz, chairman of the New York Assembly’s Judiciary Committee. Fiduciary regulations have been introduced in some states, including New Jersey,

Massachusetts, and Nevada. Other states may be waiting to see how the SEC's Regulation BI plays out and whether court challenges to state regulations are successful.

### **FINRA Launches Reg BI Webpage, Plans Workshops**

On August 7, 2019, FINRA issued a notice to its members in connection with the SEC's adoption of a best interest standard of conduct for broker-dealers and a relationship summary (Form CRS) delivery obligation. FINRA announced that it created a webpage for Regulation BI ([finra.org/rules-guidance/key-topics/regulation-best-interest](https://www.finra.org/rules-guidance/key-topics/regulation-best-interest)) where members can obtain information about the new rules. FINRA will produce written and online content to assist firms, as appropriate. Moreover, FINRA plans to hold in-person meetings and workshops to assist firms with their implementation efforts. FINRA will announce these initiatives through various communication channels, including website announcements and e-mails to firms.

### **SEC Posts Videos to Help Investors Identify Brokers vs. Investment Advisers**

On August 15, 2019, the SEC posted videos designed to highlight the differences between brokers and investment advisers. In the five videos, Jay Clayton, SEC Chairman, walks viewers through the services and costs associated with each business model. The videos, which were produced in-house at the SEC, are part of the investor education campaign the SEC launched after approving Regulation BI and its related regulatory package.

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*"We at the SEC want you to be armed with the information to ask the right questions and make the choices that are best for you—whether that means going with an investment adviser, a broker or a combination of the two," said Chairman Jay Clayton.*

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### **SEC Releases Proxy Voting Guidance for Investment Advisers**

On August 21, 2019, the SEC issued guidance to assist investment advisers in fulfilling their proxy voting responsibilities, particularly where they use the services of a proxy advisory firm. The guidance discusses, among other things: (i) how an investment adviser and its client, in establishing their relationship, may agree upon the scope of the investment adviser's authority and responsibilities to vote proxies on behalf of that client; (ii) what steps an investment adviser, who has assumed voting authority on

behalf of clients, could take to demonstrate it is making voting determinations in a client's best interest and in accordance with the investment adviser's proxy voting policies and procedures; (iii) considerations that an investment adviser should take into account if it retains a proxy advisory firm to assist it in discharging its proxy voting duties; (iv) steps for an investment adviser to consider if it becomes aware of potential factual errors, potential incompleteness, or potential methodological weaknesses in the proxy advisory firm's analysis that may materially affect one or more of the investment adviser's voting determinations; (v) how an investment adviser could evaluate the services of a proxy advisory firm that it retains, including evaluating any material changes in services or operations by the proxy advisory firm; and (vi) whether an investment adviser who has assumed voting authority on behalf of a client is required to exercise every opportunity to vote a proxy for that client. In addition, the SEC issued an interpretation that proxy voting advice provided by proxy advisory firms generally constitutes a "solicitation" under the federal proxy rules and provided related guidance about the application of the proxy antifraud rule to proxy voting advice. The guidance and interpretation will be effective upon publication in the Federal Register.

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*"The releases reiterate the Commission's views on the importance of investment advisers voting responsibly on behalf of their clients and the applicability of our proxy rules to proxy voting advice. Advisers who vote proxies must do so in a manner consistent with their fiduciary obligations and, to the extent they rely on voting advice from proxy advisory firms they must take reasonable steps to ensure the use of that advice is consistent with their fiduciary duties. In addition, proxy advisory firms, to the extent they engage in solicitations, must comply with applicable law."*  
— Commissioner Elad Roisman

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### **OCIE Issues Risk Alert Regarding Investment Adviser Principal and Agency Cross Trading Compliance Issues**

On September 4, 2019, the OCIE issued a risk alert concerning compliance issues with principal trading and cross trading transactions. The OCIE conducted examinations of investment advisers and identified deficiencies or weaknesses related to principal trading and agency cross transactions under Section 206(3) of the Investment Advisers Act of 1940 (the "Advisers Act"). The examinations revealed that advisers engaged in principal trading and arranged trades between clients and

affiliated brokers (known as agency cross trading) in each case without following the strict rules governing such transactions. The risk alert details the disclosure and consent provisions of Section 206(3) and goes on to note that compliance with these provisions alone will not satisfy an adviser's fiduciary obligations with respect to a principal or agency cross trade. To ensure that a client's consent to a principal trade or agency cross transaction is informed, the SEC has stated that Section 206(3) should be read together with Advisers Act Sections 206(1) and (2) to require the adviser to disclose facts necessary to alert the client to the adviser's potential conflicts of interest in a principal trade or agency cross transaction. The risk alert lists examples of the most common deficiencies or weaknesses identified by OCIE staff and concludes by encouraging advisers to review their written policies and procedures and the implementation of those policies and procedures to ensure that they are compliant with the principal trading and agency cross transaction provisions of the Advisers Act and the rules thereunder.

### **FINRA Will Defer to SEC on Interpreting Best Interest Rule**

Speaking at the North American Securities Administrators Association Annual Conference on September 9, 2019, FINRA chief executive Robert W. Cook discussed the implementation of SEC's Regulation BI, a new investment advice standard for brokers. He said that, while FINRA will be responsible for examining brokers for compliance with the standard, the SEC will make the final call on determining how the regulation will work. Changes will need to be made to FINRA's guidelines that align non-cash compensation rules with the SEC's ban on sales contests under the new standard. The new regulation will shift FINRA's examiners away from using the current suitability standard for broker recommendations. Cook indicated that he does not want FINRA interpreting Regulation BI; rather, he would like FINRA to develop a strong process with the SEC to ensure that the interpretive questions come up in the exam process.

### **State Attorneys General Sue SEC Over "Watered-Down" Broker Conduct Rule**

Eight attorneys general filed a complaint on September 9, 2019, in a New York federal court asking the court to vacate the SEC's newly-adopted Regulation BI. The attorneys general—from California, Connecticut, Delaware, Maine, New Mexico, New York, Oregon, and the District of Columbia—claim the SEC overstepped its rulemaking authority when adopting Regulation BI in violation of the Administrative Procedure Act. The lawsuit takes issue with two main aspects of the rule. First, it alleges that Regulation BI fails to

meaningfully evaluate broker-dealer standards beyond their existing suitability requirements. Second, the suit claims that Regulation BI relies on a vague "best interest" standard while failing to actually require that brokers act in customers' best interests, which will leave investors even more confused about the duties of broker-dealers. The attorneys general claim that the regulation falls short of the standard contemplated by the Dodd-Frank Act. The states and consumer advocates generally insist Regulation BI is too weak to help clients, while the SEC says it improves investor protections while preserving the broker-dealer industry's business model.

### **FINRA Issues Guidance on Disclosure Innovation**

On September 19, 2019, FINRA issued a regulatory notice addressing disclosure innovations in advertising and other communications with the public. FINRA's communications Rules 2210 through 2220 are based on the principles of ensuring that member communications are fair and balanced, and that investors do not receive misleading information. The notice responds specifically to questions that FINRA has received from member firms about how they can comply with FINRA rules when communicating with their customers. FINRA's goal in issuing the notice is to help facilitate simplified and more effective disclosures. The following topics were addressed: (i) innovative design techniques in member communications; (ii) how to ensure required disclosure is not overshadowed by additional disclosure; (iii) limiting disclosures to the content of what the communication promotes; (iv) how extensive disclosure within the marketing message itself should be; and (v) disclosures required in non-promotional communications (i.e., educational materials or reference resources).

### **Division of Investment Management Issues Notice Regarding Principal Risks Disclosure**

In September 2019, the SEC's Division of Investment Management issued a notice regarding principal risks disclosure by mutual funds in their prospectuses. The notice described different approaches to disclosure that the division staff believed would improve principal risks disclosures for investors. Funds were urged to list their principal risks in order of importance, with the most significant risks appearing first, rather than alphabetizing the principal risks. The division recommended that fund groups avoid generic, standardized disclosure across funds, especially where different funds in the fund group have differing investment objectives and policies. Rather, fund groups should tailor their principal risk disclosure for each fund. In addition, the division staff encouraged funds to consider disclosing when a fund is not appropriate for

certain investors given the fund's characteristics. Finally, the division suggested that funds periodically review their risk disclosures, including the order of their risks, and consider whether the disclosures remain adequate in light of the fund's characteristics and market conditions.

## **SEC Adopts New Rule to Modernize Regulation of Exchange-Traded Funds**

On September 26, 2019, the SEC announced that it has voted to adopt a new rule and form amendments that are designed to modernize the regulation of exchange-traded funds ("ETFs"), by establishing a clear and consistent framework for the vast majority of ETFs operating today. Rule 6c-11 will permit ETFs that satisfy certain conditions to operate within the scope of the Investment Company Act of 1940 and come directly to market without the cost and delay of applying for and obtaining exemptive relief. The adoption will facilitate greater competition and innovation in the ETF marketplace, leading to more choice for investors. In addition, the SEC voted to issue an exemptive order that further harmonizes related relief for broker-dealers.

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*"Since ETFs were first developed over 27 years ago, they have provided investors with a number of benefits, including access to a wide array of investment strategies, in many cases at a low cost," said SEC Chairman Jay Clayton. "As the ETF industry continues to grow in size and importance, particularly to Main Street investors, it is important to have a consistent, transparent, and efficient regulatory framework that eliminates regulatory hurdles while maintaining appropriate investor protections."*

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## **SEC Adopts New Rule to Allow All Issuers to "Test-the-Waters"**

On September 26, 2019, the SEC announced that it has voted to adopt a new rule that extends a "test-the-waters" accommodation—currently a tool available to emerging growth companies or "EGCs"—to all issuers. Under the new rule, all issuers will be allowed to gauge market interest in a possible initial public offering or other registered securities offering through discussions with certain institutional investors prior to, or following, the filing of a registration statement. The new rule is one of several SEC initiatives that build on the Jumpstart Our Business Startups Act (the "JOBS

Act") provisions intended to encourage companies to access public markets. The rule will become effective 60 days after publication in the Federal Register.

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*"The final rule benefits from the staff's experience with the test-the-waters accommodation that has been available to EGCs since the JOBS Act," said SEC Chairman Jay Clayton. "Investors and companies alike will benefit from test-the-waters communications, including increasing the likelihood of successful public securities offerings."*

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## **ENFORCEMENT ACTIONS**

### ***In the Matter of Fieldstone Financial Management Group LLC and Kristofor R. Behn (SEC File No.: 3-19227)***

On July 1, 2019, the SEC charged Fieldstone Financial Management Group LLC and its principal Kristofor R. Behn, both of Foxboro, Massachusetts, with defrauding retail investment advisory clients by failing to disclose conflicts of interest related to their recommendations to invest in securities issued by affiliates of Oregon-based Aequitas Management LLC. Among other things, the order finds that Behn and Fieldstone failed to disclose to their clients that Aequitas had provided Fieldstone with a \$1.5 million loan and access to a two-million-dollar line of credit, both of which had terms that created a significant financial incentive for Behn and Fieldstone to recommend Aequitas securities to their clients. The order further finds that Behn and Fieldstone made material misstatements and omissions in reports filed with the SEC, including false representations that the repayment terms of the loan from Aequitas were not contingent on Fieldstone clients investing in Aequitas. In addition, the order finds that Behn and Fieldstone fraudulently induced a client to invest one million dollars in Fieldstone. Without admitting or denying the SEC's findings, Fieldstone and Behn consented to the issuance of the order, which finds that they violated the antifraud provisions of the federal securities laws, censures Fieldstone, orders them to cease and desist from future violations, and orders them to pay, on a joint-and-several basis, disgorgement and prejudgment interest of \$1,047,971 and a penalty of \$275,000, all of which will be distributed to harmed investors. Behn will also be permanently barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization.

***In the Matter of Swapnil Rege (SEC File No.: 3-19257)***

On July 18, 2019 the SEC announced settled administrative proceedings against Swapnil Rege, a North Brunswick, New Jersey portfolio manager and trader. Rege was charged with mispricing private fund investments, resulting in a large personal bonus. According to the SEC order, from June 2016 to April 2017, while employed by the fund's adviser, Rege manipulated the inputs he used to value interest rate swaps and swap options to create the false impression that his investments for the fund were profitable. The SEC order finds that Rege's conduct artificially inflated the fund's reported returns and caused the fund to pay too much in fees. Rege received a \$600,000 bonus as a result of his inflated valuations. According to the order, the adviser ultimately fired Rege, closed the fund, and returned the excessive management fees to the fund. Without admitting or denying the findings in the SEC's order, Rege agreed to a cease-and-desist order, an associational bar and investment company prohibition with a right to apply for reentry after three years, disgorgement of ill-gotten gains of \$600,000 plus prejudgment interest, and a civil penalty of \$100,000.

***SEC v. Commonwealth Equity Services, LLC, et al. (Case No. 1:19-cv-11655 D. Mass.)***

On August 1, 2019 the SEC filed a complaint charging Commonwealth Equity Services, LLC d/b/a Commonwealth Financial Network, a registered investment adviser and broker-dealer based in Waltham, Massachusetts, with failing to disclose material conflicts of interest related to revenue sharing Commonwealth received for certain client investments. According to the SEC's complaint, since at least 2007, Commonwealth had a revenue sharing agreement with the broker that Commonwealth required most of its clients to use for trades in their accounts. Under the revenue sharing agreement, Commonwealth received a portion of the money that certain mutual fund companies paid to the broker to be able to sell their funds through the broker, if Commonwealth invested client assets in certain share classes of those funds. Between July 2014 and December 2018, Commonwealth received over \$100 million in revenue sharing from the broker related to client investments in certain share classes of "no transaction fee" and "transaction fee" mutual funds. The SEC's complaint alleges that Commonwealth breached its fiduciary duty to its clients by failing to disclose the conflicts of interest

created by its receipt of compensation through the revenue sharing agreement.

***SEC v. Strategic Capital Management, LLC and Michael J. Breton (Case No. 1:17-cv-10125 D. Mass)***

On September 6, 2019, U.S. District Judge Mark L. Wolf entered a final judgment against Massachusetts investment adviser Michael J. Breton in an SEC case that charged Breton with defrauding clients out of more than \$1.3 million. In January 2017, the SEC charged Breton and his firm, Strategic Capital Management, LLC, with fraud for engaging in a cherry-picking scheme whereby Breton placed trades through a master brokerage account and then allocated profitable trades to himself and unprofitable trades to client accounts. In February 2017, the court entered partial judgments by consent against Breton and Strategic Capital, enjoining them from violating certain sections of the Exchange Act and the Advisers Act. In March 2017, Breton was barred by the SEC from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization. The final judgment in the SEC's case orders Breton to pay disgorgement and prejudgment interest totaling \$1,326,696. His payment obligation is deemed satisfied by entry of the restitution order entered against him in a parallel criminal case in which Breton pled guilty and was sentenced to two years in prison, two years of supervised release, and ordered to forfeit \$1,326,696 and to pay restitution in the same amount.

***SEC v. McDermott Investment Advisors, LLC, et al. (Case No. 5:19-cv-04229 E.D. Pa.)***

On September 13, 2019, the SEC filed a complaint charging Dean Patrick McDermott and his firm, McDermott Investment Advisors, LLC, a Florida-based investment advisory firm, with defrauding their advisory clients and violating their fiduciary duties. The SEC alleges in the complaint that McDermott and his firm unlawfully invested their clients' funds in a version of unit investment trusts ("UIT") that carried significant transactional sales charges when another version of the same UITs was equally available without those costs. According to the SEC's complaint, McDermott and his firm violated their duties to seek best execution and to disclose all material conflicts of interest.

***SEC v. SBB Research Group, LLC, et al. (Case No. 1:19-cv-06473 N.D. III.)***

On September 30, 2019, the SEC charged SBB Research Group, LLC, a Chicago-area hedge fund adviser and its two top executives with a multi-year fraud that inflated fund values. According to the SEC's complaint, SBB Chief Executive Officer Samuel Barnett founded the firm in 2010, while still in college, raised millions from friends and family members, and invested almost exclusively in structured notes. The complaint alleges that as SBB sought outside investors, Barnett and Chief Operating Officer and Chief Compliance Officer Matthew Aven promised prospective investors that they would use "fair value" when recording investments. Instead, they used their own valuation model to artificially inflate the value of the structured notes. As a result, SBB misstated the funds' historical performance and overcharged investors approximately \$1.4 million in fees. According to the complaint,

once the valuation issues were uncovered by SEC exam staff, the defendants took steps to conceal their fraud from investors and SBB's auditor. The complaint alleges that when SBB hired an outside valuation firm in 2016, performance for its flagship fund was slashed, and SBB surreptitiously credited investors for the overcharged fees but did not disclose the underlying problem. The complaint charges the defendants with violations of the antifraud provisions of the federal securities laws and seeks permanent injunctions and civil penalties.

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