Investment Management Regulatory Update

March 29, 2019

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Rules and Regulations

SEC Staff Grants No-Action Relief, Increasing Flexibility for Certain In-Person Director Voting Requirements

On February 28, 2019, the Division of Investment Management (the "**Division**") of the Securities and Exchange Commission (the "**SEC**") issued a no-action letter (the "**Letter**"), allowing a board of directors of a registered fund or business development company to meet and take certain actions by telephone, videoconference or other similar means of communication, despite the Investment Company Act of 1940, as amended (the "**Investment Company Act**"), requirements to hold such meetings in-person, in certain circumstances where "in-person voting requirements may create a significant or unnecessary burden for funds and their boards that outweigh any benefits to fund shareholders."

According to the incoming letter (the "**Incoming Letter**"), the Independent Directors Council requested that SEC staff not recommend enforcement actions for violations of Sections 12(b), 15(c), or 32(a) of the Investment Company Act or Rules 12b-1 or 15a-4(b)(2) thereunder, if boards do not adhere to in-person voting requirements in situations where (i) directors are unable to meet in-person due to unforeseen or emergency situations, provided that no material changes to the matter are proposed to be approved, or approved, at the meeting, and directors ratify the applicable approval at the next in-person board meeting

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("**Scenario 1**"), or (ii) directors previously met in-person and discussed all material aspects of the matter but did not vote during the meeting ("**Scenario 2**").

According to the Letter, SEC staff would not recommend enforcement action, provided that the conditions of Scenario 1 or Scenario 2 are satisfied, with respect to the following board actions if not conducted in-person:

- renewal (or approval or renewal in the case of Scenario 2) of an investment advisory contract or principal underwriting contract pursuant to Section 15(c) of the Investment Company Act;
- approval of an interim advisory contract pursuant to Rule 15a-4(b)(2) under the Investment Company Act (with respect to Scenario 2 only);
- selection of the fund's independent public accountant pursuant to Section 32(a) of the Investment Company Act (with respect to Scenario 1, the accountant must be the same as the accountant selected in the immediately preceding fiscal year); and
- renewal (or approval or renewal in the case of Scenario 2) of the fund's 12b-1 plan.

According to the Letter, the SEC continues to review director responsibilities "in light of market, regulatory and technological developments" and believes that the relief granted under the Letter would not "diminish the board's ability to carry out its oversight role or other specific duties."

- **See a copy of the Letter**
- **See a copy of the Incoming Letter**

SEC Modifies Timing for Filing Non-Public Form N-PORT Data to Align with its Approach to Data Management and Cybersecurity

On February 27, 2019, the SEC, through an interim final rule (the "**Rule**"), modified the submission deadlines for registered investment companies filing non-public monthly reports on Form N-PORT. First implemented in October of 2016, Form N-PORT requires monthly reporting of certain registered investment companies' portfolio holdings in a structured data format. For a further discussion of Form N-PORT, please see the **October 31, 2016 Investment Management Regulatory Update**, and the **December 21, 2017 Investment Management Regulatory Update**.

Under the Rule, registered investment companies filing Form N-PORT are no longer required to file non-public monthly reports within 30 days after each month-end. Instead, filers will be required to maintain the relevant information in their records and file reports for each of the three months within the quarter, no later than 60 days after such quarter-end. The non-public monthly reports for the first two months of each quarter will remain non-public, while the third month's data will become public (with certain data exceptions that will remain private) upon filing. In the press release announcing the Rule, the SEC noted that it "has determined that allowing funds to report this monthly data at quarter-end – while not changing the amount or substance of the data – will allow the [SEC] to fulfill its mission while reducing its cyber risk profile." Chairman Jay Clayton further noted that he believes "this revised approach to the receipt of new, non-public monthly Form N-PORT data enables the [SEC] to receive and analyze this new data while meaningfully reducing the sensitivity of that data at the time it is transmitted to the [SEC]."

Filing Form N-PORT through the EDGAR system will begin in April 2019 for larger investment companies (i.e., those which, together with other investment companies in the same group of related investment companies, have net assets of over $1 billion) (each, a "**Large Fund**") and in April 2020 for smaller investment companies. After April 1, 2019, Large Funds will be required to begin submitting reports on EDGAR, 60 days after the end of a Large Fund's fiscal year, though it will continue, "30 days after month-

end, to maintain in their records the information that is required to be included in Form N-PORT." For example, a Large Fund with a March 31, 2019 fiscal quarter end, will file its first report on Form N-PORT on EDGAR by May 30, 2019.

- **See a copy of the Press Release**
- **See a copy of the Interim Final Rule**

SEC Seeks Public Comment on Issues Posed by Non-DVP Settlement and Digital Assets under the Custody Rule

On March 12, 2019, the Division issued a public letter (the "**Letter**") to the Investment Adviser Association, discussing issues stemming from Rule 206(4)-2 (the "**Custody Rule**") of the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"). The staff of the Division discussed and solicited comment from advisers, other market participants, and the public regarding the application of the Custody Rule to (1) trading practices that are not processed or settled on a delivery versus payment basis and (2) digital assets.

Non-DVP Settlement

According to the Letter, the Custody Rule requires all SEC-registered investment advisers that have "custody" or access to client funds or securities to keep those assets with a "qualified custodian." The Letter notes that the Advisers Act definition of "custody" includes "[a]ny arrangement (including a general power of attorney) under which [an investment adviser is] authorized or permitted to withdraw client funds or securities maintained with a custodian upon [the investment adviser's] instruction to the custodian[.]" Additionally, the Letter notes that custody also includes "authority and access to client securities and funds, not just physical possession." The Letter goes on to note that the SEC previously stated that "the Custody Rule does not apply to 'authorized trading[,]," and that "'[a]n [investment] adviser's authority to issue instructions to a broker-dealer or a custodian to effect or to settle trades does not constitute 'custody.' Clients' custodians are generally under instructions to transfer funds (or securities) out of a client's account only upon the corresponding transfer of securities (or funds) into the account. This 'delivery versus payment' arrangement minimizes the risk that an [investment] adviser could withdraw or misappropriate the funds or securities in its client's custodial account.'"

The Letter points out that this authorized trading exception does not address the authorized trading of securities that do not settle on a delivery versus payment basis ("**Non-DVP**" basis). As such, the Division believes that questions surrounding Non-DVP trading, as well as other questions and issues identified by SEC staff, should be considered by the SEC.

With a view toward gathering information on Non-DVP practices, the Letter requests input on the following points:

1. What types of instruments trade on a Non-DVP basis? How do these instruments trade?
2. Describe the risks of misappropriation or loss associated with various types of Non-DVP trading. What controls do investment advisers have in place to address the risks of misappropriation related to such trading? What types of independent checks, other than a surprise examination, do investment advisers use currently to test these controls?
3. Are there particular types of securities transactions settled on a Non-DVP basis that present greater or lesser risk of misappropriation or loss?
4. What role do custodians play in the settlement process of Non-DVP trading? What role do they play in mitigating risks of misappropriation or loss arising from such trading?

5. For advisers who currently obtain surprise examinations, what is the marginal cost of adding accounts that trade on a Non-DVP basis to the list of client accounts provided to the accountant performing the surprise examination of a sample of client accounts?

6. What challenges do investment advisers have in obtaining surprise examinations regarding Non-DVP traded securities? How do advisers to unaudited private funds that are subject to surprise examinations address these challenges?

7. Are there types of external checks that could be more effective and less costly than surprise examinations with respect to Non-DVP traded securities?

8. To what extent do Non-DVP assets appear on client account statements from qualified custodians? To what extent does an investment adviser have any influence over, or input into, whether and how such assets appear on account statements? Are there any assets that trade on a Non-DVP basis that would not appear on a qualified custodian's account statements?

9. To what extent could evolving technologies, such as blockchain/distributed ledger technology ("**DLT**"), provide enhanced or diminished client protection in the context of Non-DVP trading?

The Letter goes on to express concern about the inherent risk of misappropriation by an investment adviser in Non-DVP arrangements. The Letter further notes that the SEC has stated that "'[a]n [investment] adviser that holds clients' stock certificates or cash, even temporarily, puts those assets at risk of misuse or loss.'"

The Letter further states that, apart from the Custody Rule, investment advisers have an obligation to safeguard clients' assets and that as such registered investment advisers have an obligation to "review internal controls to reduce the risk of misappropriation or loss, and should address this risk in their compliance policies and procedures required by Rule 206(4)-7 under the Advisers Act." The Letter suggests that investment advisers who issue instructions to a broker-dealer or a custodian to effect or to settle trades through Non-DVP arrangements, should review the procedures and controls set forth in the 2009 amendments to the Custody Rule and accompanying interpretive release to reduce the risk of misappropriation.

Digital Assets

The Letter discusses the rise of the digital asset market and the practice of some advisers investing in digital assets on behalf of their clients. The Division staff, with the assistance of the staff of the SEC's Strategic Hub for Innovation and Financial Technology ("**FinHub**"), has discussed related compliance questions with interested parties. Specifically, according to the Letter, Division and FinHub staff inquired about whether and how compliance with the Custody Rule is affected by characteristics specific to digital assets (e.g., the use of DLT to record ownership, the use of public and private cryptographic key pairings to transfer digital assets, the "immutability" of blockchains, the inability to restore or recover digital assets once lost, the generally anonymous nature of DLT transactions, and the challenges posed to auditors in examining DLT and digital assets). The Letter requests additional input on this topic, including in response to the following questions:

1. What challenges and considerations specific to the custody of digital assets should the staff evaluate when considering any amendments to the Custody Rule? For example, are there disclosures or records other than account statements that would similarly address the investor protection concerns underlying the Custody Rule's requirement to deliver account statements?

2. To what extent and how are investment advisers construing digital assets as "funds," "securities," or neither, for purposes of the Custody Rule?

3. To what extent and how are investment advisers including digital assets in calculating regulatory assets under management for purposes of meeting the thresholds for registering with the SEC?

4. To what extent do investment advisers use state-chartered trust companies or foreign financial institutions to custody digital assets? Have these investment advisers experienced similarities/differences in custodial practices of such trust companies as compared to those of banks/broker-dealers?

5. What role do and should internal control reports, such as System and Organization Controls ("**SOC**") 1 and SOC 2 reports (Type 1 and 2), play in an adviser's evaluation of potential digital asset custodians?

6. How should concerns about misappropriation of digital assets be addressed and what are the most effective ways in which technology can be leveraged to address such concerns? How can client losses due to misappropriation of digital assets most effectively be remedied?

7. What is the settlement process of peer-to-peer digital asset transactions (i.e., transactions where there is no intermediary) and what risks does this process present? What is the settlement process for intermediated transactions in digital assets, such as those that execute on trading platforms or on the over-the-counter markets, and what risks does this process present?

8. To what extent and how do investment advisers construe digital assets as "securities" for purposes of determining whether they meet the definition of an "investment adviser" under section 202(a)(11) of the Advisers Act?

9. To what extent can DLT be used more broadly for purposes of evidencing ownership of securities? Can DLT be useful for custody and recordkeeping purposes for other types of assets, and not just digital asset securities? What, if any, concerns are there about the use of DLT with respect to custody and recordkeeping?

The Letter notes that, given the developing digital asset markets, additional questions may arise in the future. The request for information does not specify a deadline for input. Persons who would like to provide input on these questions are encouraged to do so by emailing IMOCC@sec.gov (and including "Custody Rule and Digital Assets" in the subject line). The Division expects that it will make all submissions pursuant to this process public at some time in the future.

- **See a copy of the Letter**

SEC Adopts Rules to Implement FAST Act Mandate to Modernize and Simplify Disclosure

On March 20, 2019, the SEC voted to adopt certain amendments (the "**Amendments**") to assist with the modernization and simplification of disclosure requirements applicable to public companies, investment advisers, and investment companies. The Amendments were initially proposed in October 2017. For a detailed discussion of the Amendments, please see the October 16, 2017 Davis Polk Client Memorandum, **SEC Releases Proposal Aimed at Simplifying Public Company Disclosure**.

According to the SEC, the Amendments are "expected to benefit investors by eliminating outdated and unnecessary disclosure and making it easier for them to access and analyze material information." The Amendments, which are consistent with the SEC's mandate under the Fixing America's Surface Transportation Act ("**FAST Act**"), are intended to "improve the readability and navigability of company disclosures, and to discourage repetition and disclosure of immaterial information." The Amendments will apply to a number of requirements under Regulation S-K and related rules and forms, and will, among

other things: (i) allow registrants to omit confidential information from most exhibits without filing a confidential treatment request; (ii) allow for flexibility in discussing historical periods in Management's Discussion and Analysis sections; (iii) update rules to account for developments since their adoption or last amendment by eliminating certain requirements for undertakings in registration statements; and (iv) incorporate technology to improve access to information.

The Amendments will become effective 30 days after publication in the *Federal Register*. For a detailed discussion of the Amendments, please see the March 28, 2019 Davis Polk Client Memorandum, **SEC Adopts Rules to Modernize and Simplify Disclosure For Public Companies**.

- **See a copy of the Press Release**
- **See a copy of the Amendments**

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

On March 20, 2019, the SEC voted to propose rule amendments (the "**Proposed Amendments**") to implement certain provisions of the Small Business Credit Availability Act and the Economic Growth, Regulatory Relief, and Consumer Protection Act impacting business development companies and registered closed-end funds (the "**Impacted Funds**").

According to the press release announcing the Proposed Amendments (the "**Press Release**"), the Proposed Amendments are intended to "improve access to capital and facilitate investor communications by [Impacted Funds]." The Press Release further notes that the Proposed Amendments "would modify the registration, communications, and offering processes available to [Impacted Funds], building on offering practices that operating companies currently use."

Specifically, the Press Release notes that the Proposed Amendments will allow Impacted Funds to use a more streamlined shelf offering process and the ability to use a short-form registration statement if it meets certain requirements. The Proposed Amendments would also allow Impacted Funds to qualify for well-known seasoned issuer ("**WKSI**") status and "benefit from the same flexibility available to operating companies that qualify as WKSIs." Additionally, the Proposed Amendments would allow for Impacted Funds to "use many of the communication rules currently available to operating companies, including the use of a 'free writing prospectus,'" and allow Impacted Funds to "satisfy their final prospectus delivery obligations by filing the prospectus with the [SEC]." The Proposed Amendments would also create a new method for interval funds, a type of closed-end fund that offers to repurchase a portion of its shares at regular intervals, to pay registration fees in a manner similar to the way that mutual funds pay registration fees. Finally the Press Release goes on to note that the Proposed Amendments would also include certain structured data requirements for Impacted Funds similar to those now required of mutual funds and exchange-traded funds, impose certain periodic reporting requirements (including certain disclosure requirements for Impacted Funds in annual reports and the requirement for closed-end funds to file current reports on Form 8-K like operating companies and business development companies currently do) and eliminate the requirement for Impacted Funds to provide new purchasers with copies of all previously-filed materials that have been incorporated by reference into a registration statement, but would allow Impacted Funds to make those documents available on a website instead.

The comment period for the proposal will be open for 60 days following publication in the *Federal Register*.

- **See a copy of the Press Release**
- **See a copy of the Proposed Amendments**

Litigation

U.S. District Court Dismisses Excessive-Fee Lawsuit against BlackRock after Eight-Day Trial

As reported in our February 28, 2019 **Investment Management Regulatory Update**, on February 8, 2019, Judge Freda L. Wolfson of the U.S. District Court for the District of New Jersey dismissed a lawsuit against BlackRock Advisors, LLC ("**BA**"), BlackRock Investment Management, LLC ("**BRIM**") and BlackRock International Limited (collectively, "**BlackRock**") after an eight-day bench trial. Judge Wolfson's opinion (the "**Opinion**"), which was sealed at the time of our February update, has since been made public.

By way of background, the suit, *In re: BlackRock Mutual Funds Advisory Fee Litigation*, consolidated four claims against BlackRock. The plaintiffs in the case (the "**Plaintiffs**") alleged that BlackRock overcharged investors in its affiliated Global Allocation Fund and Equity Dividend Fund (the "**Funds**") in violation of Section 36(b) of the Investment Company Act, which imposes fiduciary duties on investment advisers to registered investment companies regarding the advisers' receipt of compensation for services. Plaintiffs principally alleged that BlackRock charged investors in registered funds that it advised through BA more than double the advisory fees it charged to funds it sub-advised through BRIM, even though the advisory services provided were the same. In response, BlackRock principally argued that the services provided to the advised and sub-advised funds were not comparable, and therefore, the higher service fees charged to the advised funds were justified. Following an eight-day trial in August 2018, Judge Freda Wolfson ordered, in February 2019, that all claims be dismissed.

Judge Wolfson ultimately concluded that Plaintiffs had failed to meet their burden of demonstrating that the fees BlackRock charged were "so disproportionate that it could not be one that was negotiated at arm's length," as required to succeed on a Section 36(b) claim under controlling Supreme Court authority, *Jones v. Harris Associates L.P.*, 559 U.S. 335 (2010). Judge Wolfson reached this conclusion by applying the multi-factor test that the Second Circuit articulated in *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982). These factors include: (1) the nature and quality of the services provided to fund shareholders; (2) the profitability of the fund to the adviser; (3) fall-out-benefits—i.e., collateral benefits accruing to the investment adviser due to the existence of the fund; (4) economies of scale; (5) comparative fee structures; and (6) the independence and conscientiousness of the trustees.

The contours of the trial were set by Judge Wolfson's June 2018 summary judgment decision, in which she concluded that the Funds' Board of Directors (the "**Board**") acted independently and conscientiously, and thus, that its decision to approve BlackRock's fees was entitled to "substantial deference." Judge Wolfson concluded that genuine disputes of material fact existed regarding certain *Gartenberg* factors—the comparative fee structures, economies of scale, and the profitability of the funds to the adviser—and set the case for trial on those grounds. An eight-day bench trial was held in August 2018.

Judge Wolfson's post-trial findings of fact and conclusions of law thus addressed the three disputed *Gartenberg* factors, against the backdrop of her observation that Plaintiffs' trial burden was particularly high given that she had concluded the Funds' Board's fee decisions were entitled to substantial deference. At trial, Plaintiffs argued that the fifth *Gartenberg* factor—comparative fee structures—weighed in its favor because BA offered substantially the same services to the Funds as BRIM provided to the sub-advised funds, but charged substantially higher fees. Judge Wolfson concluded that the preponderance of the evidence demonstrated that BA's and BRIM's services were not comparable. First, she noted that the difference in the servicing models between BA, the primary adviser to the Funds, and BRIM, the sub-adviser to insurance funds that have their own primary advisers, was significant. The Funds had tens of thousands of shareholders compared to very few shareholders in the sub-advised funds. BA retained ultimate responsibility over all day-to-day operations of the Funds, whereas the primary insurance advisers, not BRIM, were responsible for providing services necessary for the sub-

advised funds. BRIM only provided portfolio management responsibilities. Unlike BRIM, BA was responsible for administering the Fund's compliance program, coordinating all Board and committee meetings and follow-up items, and overseeing the preparation and filing of the Funds' regulatory filings. Next, Judge Wolfson stated that BA provided significantly more services than the third-party service providers and its oversight of these service providers required substantially more effort – effort that BRIM did not undertake. According to the Opinion, BA even performed many functions on its own that BRIM does not perform. Third, Judge Wolfson noted that the support services provided by BA under separate agreements were so discrete and limited in comparison with BA's entire suite of services, that their small compensation for such limited services did not support a comparison between the advisory fees and the sub-advisory fees. Fourth, Judge Wolfson noted that BA faced all-encompassing risks that BRIM did not, including from every aspect of operations, safekeeping assets, interface of shareholders, compliance programs, and the supervision of the Funds' service providers. As a sub-adviser, BRIM did not need to consider these risks given the disparity in their responsibilities. The court proclaimed that numerous courts acknowledged the differences in risk faced by advisers to funds compared to sub-advisers of funds. Finally, the court found that the analysis conducted by expert witnesses and Lipper, Inc.—a financial services company heavily trusted for their fund fee and performance data—indicated that BA's fees were reasonable because they consistently ranked the Funds' fees between the median and low range of peer funds.

Next, Judge Wolfson addressed the fourth *Gartenberg* factor— demonstrating economies of scale— which she explained imposed a twofold burden of proof on the Plaintiff. According to the Opinion, first, Plaintiffs must show that economies of scale were actually realized. Judge Wolfson stated that this requires Plaintiffs to create a detailed analysis of each element of a transaction, over an extended period of time, over different levels of activity and demonstrate that the per-unit cost of servicing the Funds decreased as their assets increased. Second, the Judge noted that Plaintiffs must then show that the Funds and their shareholders did not share in the savings realized from the economies of scale. The court found that Plaintiffs had not demonstrated that the per-unit cost of servicing the Funds decreased as their assets increased. Instead, according to the Opinion, Plaintiffs' expert witness calculated what the assets under management were and observed that they increased substantially over time, while the expenses decreased. Moreover, the court said that Plaintiffs' expert analysis was defective because it improperly assumed that any changes in BA's allocated costs were the result of economies of scale. According to the court, this analysis did not demonstrate any causal linkage to rule out that the cost changes may have been caused by factors unrelated to scale.

Lastly, the court found that Plaintiffs failed to demonstrate that profitability—the second *Gartenberg* factor—weighed in its favor. Plaintiffs argued that BA's estimated profit margins on the Funds indicated that the advisory fees were excessive because BA provided substantially the same services to the sub-advised funds pursuant to fee schedules that, if applied to the Funds, would still result in positive profit margins for BA. According to the Opinion, this argument failed because the court found vast differences in BA and BRIM's services. As a result, Plaintiffs failed to carry their burden of demonstrating that the fees were excessive and Plaintiffs' claims were dismissed in their entirety.

This was one of three Section 36(b) advisory fee cases to go to trial in recent years. The investment advisers were victorious in each of these three cases. For a further discussion regarding *Sivolella v. AXA Equitable Life Insurance Company*, please see the September 28, 2016 **Investment Management Regulatory Update**.

- **See a copy of the Opinion**

SEC Settles Enforcement Action Against Investment Advisory and Broker-Dealer Firm for Conflict of Interest Violations

On March 5, 2019, the SEC issued an order (the "**Valley Forge Order**" or "**Order**") instituting and settling cease-and-desist proceedings against BB&T Securities, LLC ("**BB&T**"), as a successor-in-interest to Valley Forge Asset Management, LLC ("**Valley Forge**"), a former dually registered investment adviser and broker-dealer. According to the Order, Valley Forge charged advisory clients $4.7 million in excess compensation by favoring Valley Forge's in-house brokerage over third-party brokers.

According to the Order, from at least 2013 to 2016, Valley Forge made misleading statements in both its investment advisory contracts with clients and its Forms ADV Part 2A about the services and prices offered by its in-house brokerage services. According to the Order, Valley Forge offered its advisory clients three different brokerage options. The first option was the "Affiliated Brokerage" option, which allowed clients to direct their brokerage to Valley Forge's own "full service brokerage" and to negotiate their commission rates. The second option was the "Directed Brokerage" option, which allowed clients to designate a third-party broker-dealer and negotiate all fees for themselves. The third option was the "Discretionary Brokerage" option, which instead allowed Valley Forge the discretion to select the broker-dealer for clients on each trade. According to the Order, Valley Forge disclosed to its clients that if they chose the first option, Valley Forge would benefit monetarily and it "may be viewed as creating a conflict of interest." Despite this disclosure, approximately 59% of their advisory clients chose the first option.

The SEC alleged that Valley Forge mislead clients about its services by stating that the affiliated brokerage option offered "full service brokerage services," which the SEC alleged gave clients the misleading impression that they would receive a high level of service at low cost, and misrepresented that other, cheaper options did not offer the same services. According to the SEC, Valley Forge also made misleading statements regarding the cost associated with its affiliated brokerage option by saying that similar services "may be offered at higher or lower prices" when, in fact, the prices of competing brokers were significantly lower. The SEC further alleged that Valley Forge charged its affiliated brokerage clients higher commissions compared to those paid by clients who chose either of the other two brokerage options, while providing the same services whether clients selected affiliate brokerage or other options.

According to the Order, because clients who chose the affiliated brokerage option paid excessive fees that "inured largely to the benefit of Valley Forge," Valley Forge did not adequately disclose the conflict of interest raised by its affiliated brokerage program. As a result of these alleged misleading statements, the Order states that Valley Forge obtained approximately $4.7 million in excess compensation from its clients. In 2015, when BB&T acquired Valley Forge's parent entity, prices of in-house brokerage services offered to advisory clients were subsequently reduced and the disclosures relating to the brokerage options were amended.

Based on the conduct described above, the SEC found that Valley Forge, and BB&T as successor-in-interest to Valley Forge, violated Sections 206(2) and 207 of the Advisers Act. BB&T agreed to pay $4.7 million in disgorgement, including prejudgment interest of $497,000, and a civil money penalty of $500,000. Furthermore, the company consented to the entry of the Order and agreed to cease and desist from future violations. One notable aspect of the Valley Forge Order is that, although Valley Forge identified the potential conflict of interest and disclosed that it would benefit monetarily if clients selected the affiliated brokerage option, the SEC concluded that Valley Forge's conflict disclosures did not adequately convey the true costs and benefits of selecting the affiliated brokerage option. This underscores the SEC's careful scrutiny of adviser conflicts of interests and related disclosures, and the importance of ensuring that conflicts are adequately and accurately disclosed in advance.

- **See a copy of the Valley Forge Order**

SEC Settles with Talimco, LLC for Breaching Fiduciary Duties in Standing on Both Sides of a Mortgage Loan Participation Transaction

On March 15, 2019, the SEC issued an order (the "**Talimco Order**") instituting and settling administrative proceedings against Talimco, LLC ("**Talimco**"), a New York–based investment adviser. The SEC alleged that Talimco procured sham bids to allow an advised fund to win an auction for an asset while serving as both the seller's and the buyer's investment adviser.

According to the Talimco Order, from 2012 through 2015, Talimco served as the collateral manager and investment adviser to several collateralized debt obligation issuers (collectively, the "**CDOs**"). As the investment adviser to the CDOs, Talimco was responsible for making determinations with respect to the disposition of assets. Certain of the assets held by the CDOs were participations in a $57.2 million first mortgage on a hotel in Chicago, Illinois (the "**Mortgage Loan Participations**"). In or around July 2014, Talimco created a commercial real estate investment fund (the "**Fund**") and became the Fund's investment adviser.

Throughout 2014 and 2015, pursuant to Talimco's advice, the Fund bought the Mortgage Loan Participations from the CDOs. With respect to one such transaction, Talimco advised the Fund to buy one of the Mortgage Loan Participations from one of the CDOs. The CDO's governing documents provided that the Mortgage Loan Participation could only be sold in an auction in which bids were solicited from at least three independent market makers. According to the Talimco Order, unable or unwilling to find market makers interested in bidding on the Mortgage Loan Participation, Talimco sought solicitations from market makers who were uninterested in actually purchasing the Mortgage Loan Participation. The Talimco Order notes that at the request and solicitation of Talimco's chief operating officer, two market makers eventually made bids on the Mortgage Loan Participation, but only after assurances that they would not win the auction and after receiving direction from Talimco about the range of bids to ensure that their bid would be lower than the Fund's bid. As a result, the Fund's bid easily won the auction, and the CDO sold the Mortgage Loan Participation to the Fund. Talimco received approximately $74,000 in fees attributable to the purchase of the Mortgage Loan Participation from the CDO. Shortly thereafter, the Fund re-sold the Mortgage Loan Participation for a significant profit. Further, Talimco's chief operating officer allegedly realized personal profits of about $14,000 on the sale.

Based on the conduct described above, the SEC found Talimco willfully violated Section 206(2) of the Advisers Act, which prohibits investment advisers from directly or indirectly engaging in "any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." Without admitting or denying the charges, Talimco agreed to pay a civil money penalty of $325,000, to pay disgorgement of $74,000, to cease and desist from future violations, and to be censured. Talimco further agreed to "cooperate fully with the [SEC] in any and all investigations, litigations, or other proceedings relating to or arising from the matters" described in the Talimco Order.

- **See a copy of the Talimco Order**

SEC Announces More than $125 Million in Settlements Under the SEC's 12b-1 Fee Self-Reporting Initiative

In February 2018, the SEC unveiled the "Share Class Selection Disclosure Initiative" (the "**SCSD Initiative**"). The SCSD Initiative built on several years of emphasis by the Office of Compliance Inspections and Examinations on identifying situations in which an adviser does not adequately disclose that it receives compensation for purchasing, or recommending a client purchase, mutual fund shares of a share class that pays fees under Rule 12b-1 under the Investment Company Act, when a less expensive share class is available and appropriate for the client. As explained in our March 15, 2018 Client Memorandum, **SEC Announces Self-Reporting Initiative for Rule 12b-1 Fee Disclosures**, under the SCSD Initiative, the SEC offered "favorable" standardized settlement terms to investment advisers who self-reported potential share class selection violations by June 2018.

On March 11, 2019, the SEC announced that it had settled with 79 investment advisers who had self-reported pursuant to the SCSD Initiative. The SEC's press release announcing the settlements (the "**Press Release**") stated that the settled charges will result in more than $125 million being returned to clients, with a substantial majority of the funds going to retail investors. In conjunction with the Press Release, the SEC issued orders instituting and settling cease-and-desist proceedings against the 79 advisers who were the subjects of the announcement.

Under the standardized terms offered to these advisers, each adviser that participated in the SCSD Initiative agreed to:

- "Review and correct as necessary" all relevant disclosures regarding mutual fund share class selection and Rule 12b-1 fees;
- Evaluate whether clients should be moved into lower-fee share classes;
- "Evaluate, update (if necessary) and review for the effectiveness of their implementation" of policies and procedures designed to prevent violations of the Advisers Act in connection with share class selection;
- Notify affected investors;
- Within 40 days, certify in writing that it had complied with these undertakings; and
- Pay disgorgement and prejudgment interest (less any money that had already been distributed to investors), and distribute this disgorgement to affected investors.

Under the terms of the SCSD Initiative, the SEC did not impose civil penalties on the advisers who voluntarily self-reported under the initiative. However, the settlement orders provide that if the SEC determines that the self-reporting advisers knowingly provided materially false or misleading information to the SEC, the settling advisers cannot contest the findings in the settlement orders or assert any defense to liability or remedy.

Steven Peikin, Co-Director of the SEC's Division of Enforcement, described the SCSD Initiative as an "efficient approach to remedy a pervasive problem," which allowed the SEC to make "tremendous headway in putting money back into [investors'] hands while significantly improving the quality of firms' disclosures" in just one year. The SEC also noted that it continues to evaluate self-reports that were received during the period of the SCSD Initiative—suggesting that additional settlements may be announced in the coming months.

- **See a copy of the SEC SCSD Initiative Press Release (with links to individual settlement orders)**

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If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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