Private Equity Regulatory Update

March 29, 2019

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Rules and Regulations

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:

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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**

Litigation

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**

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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