Investment Management Regulatory Update

August 27, 2019

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Rules and Regulations

SEC Staff Grants No-Action Relief Allowing Employee Securities Companies Exempt from Registration to Continue Operating without Registration Following a Transfer of General Partner Interests in the Context of a Dissolution

On August 12, 2019, the Division of Investment Management (the "**Division**") of the Securities and Exchange Commission ("**SEC**") issued a no-action letter (the "**Letter**") to Lehman Brothers Holdings Inc. ("**Lehman**"), certain Lehman employee securities companies (the "**ESCs**"), the persons acquiring general partner interests in the ESCs and Third-Party Advisers (defined below), stating that they would not recommend enforcement action against certain ESCs for which Lehman or a Lehman affiliate acts as general partner (the "**Relief**"). According to the incoming letter (the "**Incoming Letter**"), Lehman noted that it would transfer its general partner interests in these certain ESCs and allow them to continue operations without registering as investment companies under Section 8 of the Investment Company Act of 1940, as amended (the "**Investment Company Act**").

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According to the Incoming Letter, Lehman currently serves as general partner for ESCs that were established for Lehman employees to invest side by side with Lehman-sponsored private equity funds for third-party investors (the "**Third-Party Funds**"), with such ESC funds operating as investment companies exempt from registration pursuant to a 1998 exemptive order (the "**1998 Order**"). As described in the Incoming Letter, following Lehman's Chapter 11 filing for bankruptcy protection on September 15, 2008, the advisory relationships for a majority of funds in the Lehman Brothers Private Equity Division, including the Third-Party Funds and the ESCs for which Lehman sought the Relief, were transferred to third-party advisers ("**Third-Party Advisers**"). According to the Incoming Letter, as Lehman proceeds with its plan of final liquidation, it will dispose of its remaining interests in the ESCs. Also according to the Incoming Letter, if Lehman were to dissolve the general partners, the ESCs would be required to dissolve as well. Further, the Incoming Letter notes that because of the long-term and illiquid assets held by the ESCs, it may be contrary to the best interests of the ESC limited partners for their holdings to be liquidated in connection with Lehman's liquidation. The Incoming Letter states that Lehman would like to transfer its general partner interests to Third-Party Advisers or their related persons (the "**Replacement GPs**"), who are not subject to the 1998 Order, without forcing the ESCs to register as investment companies under the Investment Company Act. The Incoming Letter notes that the 1998 Order only contemplates Lehman or its affiliates serving as general partner to the ESCs, meaning that if the Lehman entities no longer served as general partners, the 1998 Order would no longer be applicable to the ESCs. Lehman requested the Division indicate that it would not recommend enforcement if, after the transfer of general partnership interests in the ESCs to the Replacement GPs, the ESCs continue to operate without registration as investment companies, as the ESCs qualify for exemption from registration under Section 7 of the Investment Company Act. Section 7 of the Investment Company Act provides that companies engaged in "transactions which are merely incidental to the dissolution of an investment company" are not subject to the Investment Company Act registration requirements.

Under Section 3 of the Investment Company Act, companies that hold themselves out to be primarily engaged in the business of investing, reinvesting or trading in securities or companies that are primarily engaged in the business of investing, reinvesting or trading in securities must register as investment companies under the Investment Company Act unless they qualify for an exemption from registration. As stated above, Sections 7(a) and 7(b) of the Investment Company Act exempt from the registration requirements investment companies that engage in transactions that are merely incidental to their dissolution. According to the Incoming Letter, several prior SEC no-action letters have looked to the following factors when determining whether a transaction was "merely incidental to the dissolution of an investment company": (1) "The trust will exist solely to liquidate its assets and distribute the proceeds[,]" (2) "The trust will not hold itself out as an investment company, but rather as an entity in the process of liquidation[,]" (3) "The trust will not conduct a trade or business and will be limited to making temporary investments in short-term government securities, certain time deposits, certificates of deposit, bankers' acceptances, commercial paper, and money market funds[,]" (4) "The trust will terminate once its assets have been liquidated and the proceeds distributed, or [on] a specified date after the effective date of the plan of liquidation[,]" (5) "The trust will not list its interests on an exchange and the trust will not take steps designed to facilitate the development of a secondary market in the interest[,]" and (6) "The trust will be required to provide periodic reports containing financial statements and certain other information to beneficiaries of the trust."

Lehman further agreed that, "[n]otwithstanding anything to the contrary in the 1998 Order, each ESC will maintain and preserve all records for the life of such ESC and at least six years thereafter… each ESC and its respective Third-Party Adviser agree that the ESC, and any company controlled by such ESC, will not buy from or sell any security or other property to any (i) 'affiliated person' of such ESC, as such term is defined in Section 2(a)(3) of the [Investment Company] Act, or (ii) affiliated person of such person, in contravention of Section 17 of the 1940 Act, and the rules and regulations thereunder, treating each ESC as if it were a registered company for such purposes." Additionally, "in the event of a disposition of interests by a Third-Party Fund, each ESC will have the right to participate in such disposition on a basis

that is proportionate to its outstanding investments in the issuer immediately preceding the disposition." Further, the ESC's, Third-Party Advisers and Replacement GPs agree that "the ESCs will comply with the terms of the requested no-action relief" and that the ESCs will continue to comply with the conditions set forth in the 1998 Order (as modified by the terms of the requested relief) while "in dissolution." Finally, if there is a transfer of general partner interests, any such agreement "will include a term requiring the recipient to comply with the terms and conditions of the 1998 Order, as well as any terms of this letter."

According to the Letter, based on the facts and representations set forth in the Incoming Letter and pursuant to Section 7 of the Investment Company Act, the Division will not recommend that the SEC take any enforcement action against the ESCs, their Replacement GPs or Third-Party Advisers.

According to the SEC staff, because of the "very fact-specific nature of this request, however, the position expressed in this letter applies only to the entities seeking relief, and no other entity may rely on this position."

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

SEC Clarifies Investment Advisers' Proxy Voting Responsibilities

Davis Polk has published a Client Alert regarding the SEC's approval of: (1) guidance to "assist investment advisers in fulfilling their proxy voting responsibilities" (the "**Guidance**"); and (2) an interpretation that proxy voting advice provided by proxy advisory firms generally constitutes a "solicitation" subject to the federal proxy rules (the "**Interpretation**"). The Guidance and Interpretation are structured in a question and answer format that resembles the format for guidance set forth in Staff Legal Bulletin No. 20 on the Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms, issued in 2014 by the Divisions of Investment Management and Corporation Finance. However, unlike Staff Legal Bulletin No. 20, the Guidance and the Interpretation have been approved by the SEC.

Davis Polk is currently preparing client memoranda that will more fully describe the Guidance and the Interpretation.

- **See a copy of the Guidance**
- **See a copy of the Interpretation**
- **See a copy of the Client Alert**

Industry Update

Jay Clayton Speech – Regulation Best Interest and the Investment Adviser Fiduciary Duty: Two Strong Standards That Protect and Provide Choice for Main Street Investors

On July 8, 2019, SEC Chairman Jay Clayton provided remarks at Babson College regarding Regulation Best Interest ("**Reg BI**"), a new standard of conduct for SEC-registered broker-dealers and natural persons who are associated persons of a broker-dealer, new Form CRS (customer relationship summary), and new interpretations related to the fiduciary duty of registered investment advisers (the "**Fiduciary Interpretation**") and to an exemption to registration as an investment adviser for certain broker-dealers (the "**Solely Incidental Interpretation" and together with the Fiduciary Interpretation, the "Interpretations**"). Clayton also addressed certain public critiques expressed since the rulemaking package adoption by the SEC on June 5, 2019. For detailed information related to Reg BI, Form CRS and the Interpretations, please see the June 21, 2019 Davis Polk **Visual Memorandum**.

Reg BI Rules and Interpretations

Clayton first provided a brief overview of certain key components of Reg BI, Form CRS and the Interpretations.

Regulation Best Interest – Enhancing the Standards of Conduct of Broker-Dealers

Clayton explained that Reg BI imposes a new standard of conduct for broker-dealers that enhances their current "suitability" requirements. First, he noted that the new standard requires broker-dealers to "act in the best interest of their retail customers and not place their own interest ahead of the retail customer's interest." Second, Clayton noted that Reg BI is satisfied only if broker-dealers comply with four specific obligations: Disclosure, Care, Conflict of Interest and Compliance.

Fiduciary Interpretation – Affirming and Clarifying the Investment Adviser Fiduciary Duty

Clayton next highlighted the second key component of the rulemaking package – the Fiduciary Interpretation – which, he said, "reaffirms, and in some cases clarifies, certain aspects of the federal fiduciary duty that an investment adviser owes to its clients." Clayton noted that the fiduciary duty entails both a duty of care and a duty of loyalty, and that the Fiduciary Interpretation confirms the SEC's view that an investment adviser must "serve the best interest of its client and not subordinate its client's interest to its own."

Form CRS Relationship Summary – Enhancing Transparency and Comparability

Clayton next discussed the requirement that investment advisers and broker-dealers deliver a short, easy-to-understand relationship summary to their retail clients at the outset of the relationship between the investment adviser or broker-dealer and the retail client. Form CRS, Clayton said, is "designed to help retail investors select or determine whether to remain with a firm or financial professional by providing better transparency and summarizing" specific information, including information about the relationship and services, fees and costs, conflicts, standard of conduct, and any legal or disciplinary history of the financial professional.

Solely Incidental Interpretation – Clarifying Broker-Dealer and Investment Adviser Activities

Finally, Clayton explained that the Solely Incidental Interpretation confirms and clarifies the solely incidental prong of the broker-dealer exclusion from the Investment Advisers Act of 1940 (the "**Advisers Act**"). Clayton further noted that the Solely Incidental Interpretation also "illustrates the application in practice in connection with exercising investment discretion over customer accounts and account monitoring."

Response to Reg BI Criticism

Clayton then provided a pointed defense of Reg BI and the Interpretations by responding to several critiques and commentaries expressed in the weeks since Reg BI, Form CRS and the Interpretations were adopted by the SEC, some of which Clayton classified as "false, misleading, misguided," and, in other instances, "simply policy preferences disguised as legal critiques." Clayton first addressed the call by some commentators to collapse the distinction between broker-dealers and investment advisers. Clayton noted that maintaining the distinction aligns with a key goal of Reg BI – to "preserve access and choice for Main Street investors." Clayton further noted that maintaining the distinction between broker-dealers and investment advisers will allow retail investors to "choose the type and level of services they want – from occasional recommendations about particular investments to comprehensive account management – and how they want to pay for those services."

Next, Clayton continued by refuting several critical "claims" made by commentators regarding the rulemaking package.

Claim #1: The Reg BI standard of conduct will not do enough to protect retail investors.

In response to the criticism that Reg BI's standard of conduct will not sufficiently protect retail clients, Clayton stated that Reg BI and the Fiduciary Interpretation establish a standard of care that requires that a broker-dealer's or investment adviser's recommendation or advice be in "the best interest of the retail investor" and that a broker-dealer and investment adviser "cannot place the interests of the firm or the financial professional ahead of the interests of the retail investor" in a practical manner, while also maintaining the retail investor's choice as to the variety of service and fee structures. Clayton went on to highlight that the requirement to act in the best interest of a retail investor includes: (a) a disclosure obligation, which requires disclosure of all material facts regarding the relationship with the customer; (b) a care obligation, which requires brokers to exercise reasonable diligence, care and skill; (c) a conflict of interest obligation, which requires firms to implement policies and procedures to reduce or eliminate certain conflicts of interest; and (d) a compliance obligation, which requires firms to implement policies and procedures in order to comply with Reg BI. Clayton also noted that Reg BI "applies to account recommendations, including recommendations to roll over or transfer assets in a workplace retirement plan account to an [individual retirement plan]…as well as recommendations to take a plan distribution…[which] are often provided at critical moments…." He further noted that criticism stating that the failure to require the elimination of all conflicts is "misguided," as there are "conflicts of interest inherent in all principal-agent relationships."

Claim #2: Reg BI is deficient because it does not define "best interest" and does require a broker to recommend a "best" security.

Clayton continued by disagreeing with the criticism that Reg BI is inadequate because it does not define "best interest" and does not require a broker to recommend the "best" security. Clayton noted that the SEC considered this issue carefully and determined that the best approach was to apply the various obligations of Reg BI in a principles-based manner rather than in a more prescriptive fashion. Clayton went on to note that "whether a broker-dealer has acted in the retail customer's best interest will turn on an objective assessment of the facts and circumstances of how the specific components of the rule are satisfied." Clayton called the principles-based approach common and one that is used to address "issues of duty under law, particularly where the facts and circumstances of individual relationships can vary widely and change over time." With respect to the lack of requirement to recommend the "best" security, he also noted that many different products may in fact be in a retail investor's best interest.

Claim #3: The Fiduciary Interpretation weakens the existing fiduciary duty that applies to investment advisers by not requiring advisers to "put clients first."

Clayton continued by addressing the criticism that the Fiduciary Interpretation weakens the fiduciary duty requirements applicable to investment advisers. Clayton stated that the interpretation "reflects how the [SEC] and its staff have inspected for compliance, applied and enforced the law" and "reaffirms the important protections that the fiduciary duty under the Advisers Act has long provided and will continue to provide." Clayton explained that the Fiduciary Interpretation is consistent with the SEC's long-standing core principle – and what the law requires in this area – that "the adviser must at all times serve the best interest of its client and not subordinate its client's interest to its own."

Claim #4: The Fiduciary Interpretation weakens the existing fiduciary duty that applies to investment advisers by not requiring advisers to avoid all conflicts.

Clayton went on to defend against a further criticism of the Fiduciary Interpretation - that it weakens the existing fiduciary duty applicable to investment advisers by not requiring advisers to avoid all conflicts. Clayton stated that there "is no legal or regulatory basis for this claim" and that some critics have wrongly pointed to an instruction added to Form ADV by the SEC in 2010 (without public comment or commentary) as evidence of, in Clayton's words, a "newfound, independent legal requirement to an adviser to seek to avoid all conflicts." Clayton called these claims "nonsense."

Claim #5: The standards of conduct under Reg BI and the Fiduciary Interpretation can be satisfied by disclosure alone.

Clayton continued by countering the critique that the requirements of Reg BI and the Fiduciary Interpretation can be satisfied by disclosure alone. Clayton pointed again to the four component obligations of Reg BI (as discussed above: the disclosure obligation, the care obligation, the conflict of interest obligation and the compliance obligation) and indicated that, while certain conflicts of interest may be addressed by a broker-dealer via disclosure alone, a broker-dealer must satisfy all four of the Reg BI obligations to satisfy its requirements, including the care obligation, which Clayton noted, "applies to every single recommendation, regardless of whether a broker-dealer has disclosed, mitigated, or eliminated its conflicts of interest." Similarly, Clayton observed that while an investment adviser "may be able to satisfy the duty of loyalty by providing full and fair disclosure and obtaining informed consent, the adviser could not satisfy its duty of care solely through disclosure."

Claim #6: Reg BI is a weak standard because it does not require broker-dealers to monitor a customer's account or impose an ongoing duty.

Clayton went on to discuss the claim that Reg BI is deficient because it does not require broker-dealers to monitor a customer's account. Such a claim, Clayton stated, misunderstands both how federal law applies and a key goal of SEC rulemaking discussed above – to "preserve access to different levels of services and related cost structures." By maintaining options as to the types of services and fees that retail investors can choose from and not requiring broker-dealers to provide ongoing or periodic monitoring services, Clayton argued, Reg BI gives retail investors the flexibility they desire. Clayton further notes that, as discussed in the Solely Incidental Interpretation, it is not "consistent with the solely incidental prong of the broker-dealer exclusion under the Advisers Act for a broker-dealer to agree to provide continuous monitoring of a customer account…[which] would subject the broker-dealer to regulation as an investment adviser."

Claim #7: The relationship summary will not accomplish its original goals of addressing investor confusion regarding the differences between brokers and advisers.

Clayton next responded to the seventh and final critique addressed in his remarks – that the short relationship summary discussed above will not achieve its goal of helping investors understand the distinctions between brokers and investment advisers. Clayton highlighted the SEC's extensive research and testing as to the best format and content for the Form CRS and added that the form "is a substantial improvement over existing retail disclosures" that will "highlight key information in one place for retail investors." Clayton added that the form will help investors determine which firms and professionals to use. He also noted that the Form CRS is required to include a link to the Investor.gov web page, which includes additional educational resources for retail investors.

Some Tips for Retail Investors

Clayton concluded his remarks by acknowledging that while some interested parties would have preferred a different approach to better protect the interests of retail investors, the rules and Interpretations adopted are "the culmination of decades of debate" and encouraged retail investors to consider what kinds of services they want and how they would like to pay for those services. Clayton noted that he believes that Reg BI will assist retail investors as they choose financial professionals, noting that "after careful consideration, our approach addresses multiple, interrelated issues in a way that best achieves our goals of enhancing investor protection and decision making, while—again—preserving your access and choice."

- **See a transcript of the Speech**

SEC Retail Strategy Task Force Announces Roundtable Discussion on Combating Elder Investor Fraud

On July 18, 2019, the SEC announced that its Retail Strategy Task Force will host a roundtable on October 3, 2019 on combating elder investor fraud. In recent years, various SEC staff members have spoken out on the problem of elder financial abuse. According to the SEC, the roundtable will focus on the types of schemes that are currently used to target elder investors and will also explore steps that regulators, broker-dealers, investment advisers and others can take to identify and combat elder investor fraud.

- **See a copy of the Announcement**

SEC and NASAA Issue Summary Statement Regarding Federal and State Securities Laws Implications of Opportunity Zone Investments

On July 15, 2019, the SEC and the North American Securities Administrators Association ("**NASAA**") issued a joint summary statement (the "**Statement**") designed to provide participants in the "opportunity zone" program with compliance information related to the federal and state securities laws implications for qualified opportunity funds ("**QOFs**").

According to the press release accompanying the Statement, the opportunity zone program (the "**Program**") was established by the Tax Cuts and Jobs Act in December 2017 to provide tax incentives for long-term investing in communities designated as "economically distressed." According to the Statement, the Program allows taxpayers to defer and reduce taxes on capital gains by reinvesting any such capital gains in QOFs, which are required to have 90 percent or more of their assets in designated low-income census tracts ("**opportunity zones**"). According to the Statement, the U.S. Department of the Treasury has designated more than 8,700 qualified opportunity zones, which generally have a poverty rate of at least 20 percent and a median income no more than 80 percent of the applicable statewide or metropolitan average.

Federal and State Securities Considerations

According to the Statement, interests in a QOF, whether in the form of limited partnership interests, membership interests or otherwise, will typically constitute securities within the meaning of federal and state laws, except in a limited number of circumstances (e.g., a QOF established as a general partnership where each partner plays a substantial management role). As a result, according to the Statement, an offering for an interest in a QOF must comply with all applicable federal and state securities laws related to the offering of securities. Thus, from a federal perspective, any QOF offering or sale requires that the relevant interests be either: (i) registered with the SEC; or (ii) exempt from such registration. The Statement also notes that state securities laws "also require registration or an exemption from registration before securities may be offered or sold in the state." Additionally, the Statement provides that, "[e]ven if an exemption…applies, the offer and sale…are subject to the anti-fraud provisions of the federal and state securities laws…."

According to the Statement, two of the principal exemptions from registration that may be available to issuers of QOFs arise under Rules 506(b) and 506(c), both promulgated under Regulation D of the Securities Act of 1933, as amended (the "**Securities Act**"). Rule 506 generally allows any issuer of securities to raise unlimited capital and to sell securities to an unlimited number of accredited investors. The rule includes certain "bad actor" disqualification provisions and certain restrictions on transfers of securities, and it further provides that the issuer must file a notice on Form D alerting the SEC of the offering within 15 days after the first sale of securities. Under Rule 506(b), the QOF issuer is not allowed to use general solicitation or advertising to offer the securities, and offers and sales are limited to accredited investors and up to 35 sophisticated, non-accredited investors, among other restrictions. Under Rule 506(c), the QOF issuer may use general solicitation or advertising, but all investors must be

accredited investors, and the QOF issuer is tasked with taking reasonable steps to verify the accredited investor status of all investors. The Statement also notes that states "have authority to require notice filings and collect state fees[,]" even though federal law preempts state registration and qualification under Rule 506.

According to the Statement, other exemptions from registration are also available to QOF issuers, including Rule 504 of Regulation D, the intrastate offering exemption in Rules 147 and Rule 147A, Regulation A and Regulation Crowdfunding.

Investment Company Act Considerations

According to the Statement, the Investment Company Act defines an "investment company" as an issuer that: (i) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting or trading in securities; (ii) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or (iii) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding or trading in securities, and owns or proposes to acquire "investment securities" having a value exceeding 40 percent of the value of its total assets (exclusive of government securities and cash items) on an unconsolidated basis. Further, the Statement notes that QOFs are typically pooled investment vehicles through which investors contribute funds to invest in qualified opportunity zones and, depending on the particular facts of the QOF, may be required to register as investment companies under Investment Company Act, absent an exclusion from the definition of "investment company" or an exemption from registration.

According to the Statement, three definitional exclusions are of particular importance in relation to a QOF's requirement to register as an investment company: (i) Section (3)(c)(1) of the Investment Company Act; (ii) Section 3(c)(7) of the Investment Company Act; and (iii) Section 3(c)(5)(C) of the Investment Company Act. According to the Statement, Section 3(c)(1) of the Investment Company Act states, in part, that "an issuer is not an investment company if its outstanding securities (other than short-term paper) are beneficially owned by not more than 100 persons or, in the case of a qualifying venture capital fund, 250 persons, and which is not making and does not presently propose to make a public offering of its securities." Further, according to the Statement, Section 3(c)(7) of the Investment Company Act states "that an issuer will not be an investment company if its outstanding securities are owned exclusively by persons who, at the time of acquisition of such securities, are 'qualified purchasers' [as defined in Section 2(a)(51) of the Investment Company Act] and it is not making and does not at that time propose to make a public offering of its securities." Additionally, according to the Statement, for purposes of Section 3(c)(5)(C), an issuer generally will not be considered an investment company if it "is not engaged in the business of issuing redeemable securities and if, in part, it is primarily engaged in purchasing or otherwise acquiring mortgages and other liens and interests in real estate."

Advisers Act Considerations

According to the Statement, the Advisers Act defines an "investment adviser" as "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities." The Statement notes that state securities laws "generally follow this definition." Absent a definitional exclusion or exemption from registration, the Statement notes that entities meeting such definition and which have a certain level of assets under management typically are subject to SEC registration. The Statement notes that "[g]enerally, the level of assets under management triggering [SEC] registration is $100 million, although in some cases, those advisers with between $25 million and $100 million in assets under management are subject to [SEC] registration." According to the Statement, to the extent an entity involved in advising QOFs engages in the activities enumerated in the definition of "investment adviser," such entity may be required to register with the SEC or a state regulatory authority.

According to the Statement, there are a few exclusions from the definition of "investment adviser" and exemptions from registration under the Advisers Act that are of particular import with respect to QOFs and their managing entities: (i) Section 202(a)(11)(B) of the Advisers Act, (ii) Section 202(a)(11)(C) of the Advisers Act; and (iii) Rule 203(m)-1 under the Advisers Act. Section 202(a)(11)(B) excludes lawyers, accountants, engineers and teachers whose performance of any advisory services is solely incidental to the practice of their profession from the definition of "investment adviser." Section 202(a)(11)(C) excludes from the definition of "investment adviser" any broker or dealer whose performance of advisory services is solely incidental to the conduct of their business and who receives no special compensation for such advisory services. Finally, the Statement identifies Rule 203(m)-1, which provides that an entity advising only private funds and with assets under management of less than $150 million is exempt from registration with the SEC as an investment adviser.

In addition to considerations regarding the Investment Company Act and Advisers Act, the Statement also discusses considerations for broker-dealers, including potential registration requirements for those selling interests in QOFs.

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

Litigation

SEC Sues REIT Sponsor and Executives Alleged to Have Wrongfully Obtained Millions in Charges and Partnership Units

On July 16, 2019, the SEC filed a complaint in the U.S. District Court for the Southern District of New York against AR Capital, LLC ("**AR Capital**"), its founder Nicholas S. Schorsch ("**Schorsch**"), and its former chief financial officer Brian Block ("**Block**"). AR Capital is an investment management firm that managed several real estate investment trusts ("**REITs**"), including American Realty Capital Properties, Inc. ("**ARCP**"), a publicly traded REIT. The SEC alleged that AR Capital, Schorsch, and Block wrongfully obtained millions of dollars in excess compensation by manipulating incentive fee calculations in contravention of the REITs' governing documents and disclosures to shareholders.

According to the complaint, AR Capital sponsored and managed ARCP, as well as two publicly held, non-traded REITs, American Realty Capital Trust III, Inc. ("**T3**") and American Realty Capital Trust IV, Inc. ("**T4**"). The governing documents of T3 and T4 provided that if shareholders received a certain level of return through a "liquidity event" such as a merger or public listing, AR Capital would receive a "subordinated distribution," otherwise called a "promote fee," paid in operating partnership units of the respective REIT. The SEC alleged that in connection with T3's merger with ARCP, the defendants inflated the "promote fee" by deviating from the calculation disclosed to investors. Instead, defendants allegedly used a variety of calculations that departed from the disclosed methodology in ways designed to inflate the fee, such as by calculating the fee based on the five-day trailing average price of ARCP stock instead of the (lower) closing price on the date of the merger, but using the merger date closing price for other calculations in which a lower share price would further increase the size of the promote fee. The SEC further alleged that defendants also inflated the promote fee received in connection with the merger of T4 with ARCP through calculations that deviated from the disclosed methodology, including by calculating the fee based on a lower "insider price" of T4 units rather than the higher fair value of T4 common stock on the date of the merger closing, as required by disclosures to investors and the operative agreements.

Together, these alleged manipulations resulted in receipt of over 2.9 million additional operating partnership units of ARCP to which they were not entitled. The complaint also alleges that the defendants directed the creation and/or approval of misleading purchase and sale agreements in connection with the mergers that allowed AR Capital to receive $5.8 million from ARCP and the defendants to wrongfully

obtain at least $7.27 million in unsupported charges. The SEC alleges that AR Capital and Block violated the antifraud provisions of Section 17(a) of the Securities Act and Section 10(b) of the Securities Exchange Act of 1934 (the "**Exchange Act**") and Rule 10b-5 thereunder, and that Schorsch negligently violated the antifraud provisions of Section 17(a)(2) and (3) of the Securities Act. The complaint also charges each of the defendants with falsifying ARCP's books and records in violation of Section 13(b)(5) of the Exchange Act and Exchange Act Rule 13b2-1. The SEC seeks a final judgment permanently enjoining the defendants from engaging in their alleged actions, requiring the defendants to disgorge profits and pay prejudgment interest and imposing civil money penalties on the defendants pursuant to Section 21(d)(3) of the Exchange Act.

- **See a copy of the AR Capital Complaint**

SEC Settles with Former Investment Adviser for Engaging in Unauthorized Security Allocations to Client Accounts

On July 31, 2019, the SEC issued an order (the "**Brosk Order**") instituting and settling cease-and-desist proceedings against Jonathan Brosk ("**Brosk**"), arising out of alleged unauthorized security allocations he made to client advisory accounts while employed at an investment advisory firm ("**Firm A**").

According to the SEC, during his time at Firm A, Brosk had both discretionary authority over, and access to, trade securities in his clients' accounts, including Individual Retirement Accounts and Firm A's block account, which was used to aggregate bulk trades for Firm A's clients. Among the securities that Brosk traded for clients were call options, both covered and uncovered. If clients agreed to the trading of call options, they were required to sign an Options Account Agreement ("**Options Agreement**") that indicated, among other things, the types of options that they would permit Firm A to trade on their behalf. According to the Brosk Order, in the Options Agreement, Firm A cautioned clients that investing in uncovered call options was risky, and that trading such options could result in potential losses. A majority of clients did not authorize the trading of uncovered call options.

The SEC alleged that between January 2016 and September 2016, on at least ten different occasions and across approximately 50 client accounts, Brosk engaged in "potentially risky" trading of uncovered call options and improperly allocated to clients the sales and purchases of those options even though these clients had not authorized writing uncovered calls. This process often included Brosk "sell[ing] to open" the "uncovered calls" in Firm A's block account, then "buy[ing] to close" the positions in that account, sometimes immediately after selling to open. Ultimately, the sales and purchases of those uncovered call options were allocated to clients' accounts, yielding net profits to them of approximately $8,200. In addition, the SEC alleged that a large number of uncovered call options were also allocated to Brosk's parents' accounts, yielding net profits of roughly $11,500. According to the Brosk Order, Brosk made these trades in an attempt to improve the performance of clients' accounts, notwithstanding the fact that he knew he was exposing clients to the high risks associated with trading uncovered calls, and that it was against company policy to trade uncovered call options in individual retirement accounts.

As a result of the conduct described above, the SEC found that Brosk willfully violated Section 206(1) and Section 206(2) of the Advisers Act. In addition, the Brosk Order further found that Brosk violated Section 10(b) of the Exchange Act, and Rule 10b-5(a) and (c) thereunder. As a result, Brosk agreed to pay a civil monetary penalty of $25,000. Brosk also consented to the entry of the Brosk Order and agreed to cease and desist from future violations.

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

SEC Sues Advisory Firm for Alleged Conflicts of Interest Regarding Mutual Fund Share Class Selection

On August 1, 2019, the SEC filed a complaint against Commonwealth Equity Services, LLC ("**Commonwealth**"), an investment adviser, for allegedly failing to disclose adequately conflicts of interest arising out of certain revenue-sharing agreements that created a financial incentive for Commonwealth to select investments that were more expensive for its clients but generated greater revenues for Commonwealth. The Commonwealth complaint is consistent with the SEC's focus on conflicts of interest relating to mutual fund share class selection, which was the subject of an SEC initiative reported in prior updates in 2018 and 2019.[1]

According to the SEC complaint, since 1998, Commonwealth had contracted with National Financial Services, LLC ("**NFS**") to maintain custody of Commonwealth's clients' assets and to act as a clearing broker. NFS offered certain mutual funds through a "no transaction fee" program, in which investors did not pay a transaction fee to purchase shares of certain mutual funds, and a "transaction fee" program through which investors would pay fees to purchase shares. Since 2007, the SEC alleges, NFS agreed to share with Commonwealth some of the revenue NFS received from mutual funds that participated in the no transaction fee program, with the exception of mutual funds sponsored by Fidelity Investments. NFS also agreed to share with Commonwealth a portion of fees associated with purchases of mutual fund shares through the transaction fee program.

The SEC alleged that Commonwealth's receipt of a share of NFS's fees caused Commonwealth's interests to conflict with the interests of its clients. Commonwealth had an incentive to select and hold mutual fund shares in certain classes that generated greater revenue for Commonwealth even if more expensive for its clients, and within the same fund, to select and hold share classes that paid greater fees—for example, to select a share class that participated in the no transaction fee program even though a share class available through the transaction fee program would have lower ongoing expenses to clients.

In the SEC's view, Commonwealth's disclosures to investors were materially deficient in at least two ways. First, Commonwealth *did* disclose, in its Form ADV, that "[p]articipating mutual fund sponsors pay a fee to NFS to participate in [the no transaction fee] program, and a portion of this fee is shared with Commonwealth." But, the SEC alleged that this disclosure was misleading because, among other things, Commonwealth *did not* disclose, until 2017, that mutual funds that participated in the "no transaction fee" program and revenue sharing were generally more expensive to Commonwealth's clients compared to those mutual funds in a "transaction fee" program, and that there were mutual funds participating in the no transaction fee program with lower-cost share classes available.

Second, Commonwealth amended its disclosures in 2017 to state that "[c]lients, however, should be aware that funds available through the [no transaction fee] program may contain higher internal expenses than mutual funds that do not participate in the [no transaction fee] program, and could present a potential conflict of interest because Commonwealth may have an incentive to recommend those products." The SEC alleged that this disclosure, too, was misleading because it framed the conflict of interest as "potential" and that Commonwealth "may" have an incentive to recommend those products when, according to the SEC, Commonwealth *in fact had an actual conflict* and incentive to recommend more expensive funds. The SEC contends that Commonwealth operated under an undisclosed conflict of

[1] We reported on the Share Class Selection Disclosure Initiative in March 2018 (*see* "**SEC Announces Self-Reporting Initiative for Rule 12b-1 Fee Disclosures**") and noted that the SEC announced in March 2019 that it had settled with 79 investment advisers who had self-reported disclosures regarding improper mutual fund share class selection (*see* "**SEC Announces More than $125 Million in Settlements Under the SEC's 12b-1 Fee Self Reporting Initiative**").

interest, which, in turn, demonstrated that Commonwealth also failed to adopt and implement policies and procedures reasonably designed to identify and disclose conflicts of interest.

The SEC's allegations regarding Commonwealth's disclosures underscore that the SEC will often view disclosures warning of a "potential" conflict or that an adviser may receive revenue on account of certain decisions are not adequate to warn investors that an *actual* conflict exists and the circumstances giving rise to the conflict. The complaint also underscores that conflicts of interest are a perennial focus of SEC examinations and enforcement. As just one recent example, the SEC's Office of Compliance Inspections and Examinations ("**OCIE**"), in a July 23, 2019 risk alert, identified "whether the adviser identified, addressed, and fully and fairly disclosed all material conflicts of interest that could affect the advisory relationship, particularly those conflicts dealing with compensation arrangements and account management" as a focus of a recent exam initiative. For a further discussion regarding the July 23, 2019 OCIE risk alert, please see the July 31, 2019 **Investment Management Regulatory Update**.

On account of these alleged failures, the SEC asserts that Commonwealth violated Sections 206(2) and 206(4) of the Advisers Act, and Rule 206(4)-7 thereunder. The SEC seeks a permanent injunction restraining Commonwealth from engaging in the alleged conduct, disgorgement of unjust enrichment, prejudgment interest, and civil penalties in an unspecified amount.

- **See a copy of the Commonwealth Complaint**

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