Investment Management Regulatory Update

May 27, 2016

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SEC Rules and Regulations

SEC Proposes Higher Net Worth Threshold for Qualified Clients under the Advisers Act

On May 18, 2016, the SEC issued a notice of its intent to issue an order increasing the dollar amount thresholds in Rule 205-3 under the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"), which permits investment advisers to charge performance-based fees to "qualified clients." The SEC explained that it was adjusting such amounts to account for inflation, and that the order would increase the minimum net worth that a qualified client must have under the rule, but would not increase the minimum dollar amount of assets under management of the adviser that a qualified client must have.

Section 205(a)(1) of the Advisers Act generally prohibits an investment adviser from entering into any investment advisory contract that provides for compensation to the adviser based on a share of capital gains on, or capital appreciation of, the funds of a client (such compensation, "performance-based compensation" or "performance fees"). In 1985, the SEC adopted Rule 205-3 under the Advisers Act ("**Rule 205-3**") generally to exempt investment advisers from the prohibition against charging a client performance fees if such client had at least $500,000 under management with the adviser or if the adviser reasonably believed, immediately prior to entering into the contract, that the client had a net worth of more than $1 million. In 1998, these amounts were increased to $750,000 and $1.5 million, respectively. The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") amended Section 205(e) of the Advisers Act to generally require that the SEC adjust dollar amount thresholds included in rules issued under Section 205(e) every five years (rounded to the nearest $100,000), and in July 2011, the SEC issued an order revising the dollar amount thresholds in the definition of "qualified client" referred to above to $1 million and $2 million, respectively. In February 2012, the SEC adopted amendments to Rule 205-3 providing that the SEC would issue an order every five years in the future adjusting the dollar amount thresholds for inflation, specifying that the Personal Consumption Expenditures Chain-Type Price Index ("**PCE Index**"), which is published by the U.S. Department of Commerce, should be used to make future inflation adjustments.

The SEC's May 18 notice thus provides that, pursuant to Section 418 of the Dodd-Frank Act and Rule 205-3(e), the SEC intends to issue an order increasing the dollar amount of the net worth test in the definition of "qualified client" in Rule 205-3 from $2 million to $2.1 million and retaining the dollar amount of the assets under management test at $1 million. The notice did not specify when the SEC expects to issue such order (although it did state that interested persons should request a hearing by June 13, 2016), but noted that the SEC anticipates that the effective date of the new dollar amount of the net worth test would be 60 days following the order date.

- **See a copy of the Notice**

SEC Staff Grants No-Action Relief under Section 206(3) of the Advisers Act for Certain Purchases of Fractional Shares from Advisory Client Accounts by Advisers and Their Broker-Dealer Affiliates

On April 14, 2016, the staff of the Division of Investment Management of the Securities and Exchange Commission (the "**SEC**") issued a no-action letter (the "**Letter**") to J.P. Morgan Securities LLC ("**JPMS**") giving relief from Section 206(3) of the Advisers Act, to investment advisers and their broker-dealer affiliates who purchase fractional shares from clients without the clients' advance consent, provided that certain conditions are met.

According to the incoming letter (the "**Incoming Letter**"), JPMS is dually registered with the SEC as a broker-dealer and an investment adviser, and certain other of its affiliates are registered as investment advisers (such affiliates, together with JPMS, the "**Advisers**"). The Incoming Letter represents that the Advisers hold discretionary management authority over client accounts which hold individual securities and, for various reasons, may come to hold "fractional shares" (i.e., less than one full share of an exchange-traded equity security) that are not issued by the issuer of such security but rather consist of account entries representing what an account holder would be entitled to receive if such fractional shares could be traded in the marketplace. According to the Incoming Letter, since fractional shares are not traded in the marketplace, however, the Advisers must find a way to monetize those shares on behalf of the advisory client. The Incoming Letter proposed that, when an account holds a fractional share and JPMS determines to sell out of a position consisting of whole shares and fractional shares, JPMS or one of its broker-dealer affiliates would purchase the fractional shares from the client account on the same day and at the same price at which the whole shares are sold. The Incoming Letter further proposed that if the whole shares are transferred for some reason other than a sale, JPMS or its broker-dealer affiliate would purchase the fractional shares at the market's closing price for whole shares on the day of the transfer.

Pursuant to Section 206(3) of the Advisers Act ("**Section 206(3)**"), an investment adviser may not, directly or indirectly, acting as principal for its own account, knowingly sell any security or purchase any security from an advisory client without disclosing to such client in writing, before such transaction is complete, the capacity in which it is acting and obtaining the client's consent to such transaction. The SEC generally interprets Section 206(3) also to apply to transactions between an advisory client and the adviser's affiliate. The Letter explained that Section 206(3) is intended to address potential self-dealing that can arise when an investment adviser trades with clients on a principal basis, including the potential for price manipulation. In the Incoming Letter, JPMS represented that price manipulation would not be a concern in the scenario set forth above because trades would be conducted at the market price for the whole shares, and that requiring disclosure and consent to each such transaction would place a disproportionate burden on JPMS and its clients.

According to the Letter, the SEC would not recommend enforcement action under Section 206(3) based on the facts and representations in the Incoming Letter. Specifically, the Letter noted the Incoming Letter's representations that: (1) the value of the fractional share transactions would be immaterial to both the client and the Advisers and their broker-dealer affiliates; (2) the price of the transaction would be determined by the sale price for the whole shares (in cases where the whole shares were sold) or by that day's closing price for whole shares (in connection with all other transfers of whole shares); (3) the Advisers and their broker-dealer affiliates would not receive commissions or other compensation in connection with the purchase of the fractional shares; (4) the Advisers would not determine the timing of the principal transaction, but rather the transaction would be conducted in connection with the transfer of the whole shares; and (5) the Advisers would disclose the practice of purchasing fractional shares in their Forms ADV and such transactions would be reflected in trade confirms and account statements as principal trades.

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

SEC Staff Grants No-Action Relief under the Custody Rule to Sub-Adviser for Not Obtaining Surprise Examination of Custodian Affiliate

On April 25, 2016, the staff of the Division of Investment Management of the SEC issued a no-action letter (the "**Letter**") to the Investment Adviser Association, clarifying that it would not recommend enforcement action under Section 206(4) of the Advisers Act and Rule 206(4)-2 thereunder (the "**Custody Rule**") if an investment adviser does not obtain a surprise examination where it acts as a sub-adviser in an investment advisory program for which a related person qualified custodian is the primary adviser (or an affiliate of the primary adviser), and the primary adviser is responsible for complying with the Custody Rule.

The SEC noted that, under the Custody Rule, a registered investment adviser with custody of client funds or securities is required to take a number of steps designed to safeguard those client assets, including, generally when it has custody of client assets, undergoing an annual surprise examination by an independent public accountant to verify the client funds and securities. According to the Letter, affiliated custodial relationships present higher risks to advisory clients than where client funds or securities are maintained with an independent custodian. As such, where an investment adviser or its related person maintains client funds or securities, clause (a)(6) of the Custody Rule further requires the investment adviser to obtain or receive a written internal control report from an independent public accountant that demonstrates that it or its related person has established appropriate custodial controls.

The SEC clarifies in the Letter, however, that the staff would not recommend enforcement action to the SEC under the Custody Rule if an investment adviser acting as a sub-adviser does not obtain a surprise examination when a related person qualified custodian is the primary adviser (or an affiliate of the primary adviser) under the following conditions:

- (1) the sole basis for the sub-adviser's having custody is its affiliation with the qualified custodian and the primary adviser;
- (2) the primary adviser will comply with the Custody Rule, including by having client funds and securities in the investment advisory program verified by a surprise examination conducted by

an independent public accountant registered with the Public Company Accounting Oversight Board ("**PCAOB**") pursuant to an agreement entered into by the primary adviser;

- (3) the sub-adviser does not (i) hold client funds or securities itself; (ii) have authority to obtain possession of client funds or securities; or (iii) have authority to deduct fees from client accounts; and
- (4) the sub-adviser will be required to obtain from the primary adviser or qualified custodian, on an annual basis, a written internal control report prepared by an independent public accountant registered with and subject to regular inspection by the PCAOB as required by the Custody Rule.

- ▸ **See a copy of the Letter**

Incentive Compensation for Financial Institutions: Reproposal

The National Credit Union Administration, the Federal Deposit Insurance Corporation, the Office of the Comptroller of Currency, the Federal Housing Agency, the SEC and the Board of Governors of the Federal Reserve System jointly issued a proposed rule (the "**Proposed Rule**") implementing Section 956 of the Dodd-Frank Act regarding incentive compensation paid by covered financial institutions, including investment advisers. An earlier version of the rule was proposed in 2011. Davis Polk will be issuing a client memorandum discussing how the Proposed Rule applies to investment advisers shortly. For further discussion of the proposal more generally, please see the May 2, 2016 Davis Polk Visual Memorandum, **Incentive Compensation for Financial Institutions: Reproposal**.

Industry Update

Financial Stability Oversight Council Releases Update on Review of Asset Management Products and Activities

On April 18, 2016, the Financial Stability Oversight Council ("**FSOC**") released a statement providing an update on its review of potential risks to U.S. financial stability posed by certain asset management products and activities (the "**Statement**"). The Statement builds on FSOC's ongoing review of the asset management industry, including its public conference in May 2014 and its July 2014 directive to undertake a more focused analysis of the asset management industry and its products. The Statement focuses on the areas of potential financial stability risk highlighted in FSOC's December 2014 request for public comment, namely on: (1) liquidity and redemption; (2) leverage; (3) operational functions; (4) securities lending; and (5) resolvability and transition planning. For each category, FSOC provided its thoughts on steps to mitigate potential financial instability, noting those areas where additional information and analysis are still needed to properly analyze potential risks. According to the Statement, FSOC intends to consider the impact of regulatory developments in mitigating the risks to U.S. financial stability associated with the asset management sector, and it considered the potential impact of certain proposed SEC rulemakings in its analysis. SEC Chair Mary Jo White issued a brief response to the Statement on the same day the Statement was released.

Liquidity and Redemption Risk. FSOC's review of liquidity and redemption risk focused on pooled investment vehicles and mutual funds in particular. According to the Statement, two primary features of pooled investment vehicles raise potential financial stability concerns: liquidity transformation and first-mover advantage:

A. *Liquidity Transformation*

According to the Statement, certain pooled investment vehicles, especially open-end funds, provide liquidity transformation by permitting frequent and often daily redemptions for investors while investing in less-liquid assets. In turn, investors may require a lower liquidity premium than investors purchasing the underlying assets directly, which may increase the bid price of such underlying assets. If the market encounters a stress event and large redemptions occur, forcing a sale of the underlying assets, the prices of the underlying assets held by such funds may fall rapidly.

B. *First-Mover Advantage*

According to the Statement, funds' redemption options and pricing methods may create a first-mover advantage if redemption costs are largely borne by those investors remaining in the fund, potentially incentivizing some investors to redeem ahead of other investors during a market stress event to avoid such costs. In addition, according to the Statement, if a fund sells its more liquid assets first to satisfy redemption requests, it may similarly promote a first-mover advantage.

According to FSOC, funds with less-liquid assets and with redemption and pricing features promoting a first-mover advantage may face large redemptions in a stress event, causing such funds to incur significant costs beyond immediate transaction costs. Such costs, according to the Statement, may further impair performance and result in further redemptions and asset sales, which could potentially cause price decreases across an entire asset class and ultimately result in broader market disruptions. FSOC noted, however, that the degree of these risks varies depending on, among other factors, the liquidity of a fund's assets, its redemption policies, the degree of liquidity mismatch and the sensitivity of investors to fund performance and first-mover advantage.

Next, in discussing mutual funds specifically, FSOC noted that while current regulations require mutual funds to use forward pricing when calculating the price a redeeming shareholder receives for its fund shares, these funds do not generally consider the associated transaction costs, which are typically borne by the remaining investors. According to the Statement, such costs could vary widely depending on the liquidity of a fund's assets, with funds investing in more illiquid assets potentially creating first-mover advantage risk. In addition, according to the Statement, the existing 15% of net assets limit on mutual funds for holding certain illiquid assets does not take into account the size of a fund's position or longer settlement times. The risk associated with these gaps, according to FSOC, is potentially greater the less liquid the assets are which a fund holds.

To mitigate certain financial stability risks associated with the liquidity and redemption profiles of pooled investment vehicles, FSOC recommended the following steps for consideration:

- Establishing robust liquidity risk management practices among mutual funds, particularly by funds that invest in less-liquid assets;
- Creating clear regulatory guidelines regarding mutual funds' abilities to hold highly illiquid assets, in order to avoid the possibility that a mutual fund's holding of any such illiquid assets would interfere with its ability to make orderly redemptions;
- Enhancing mutual funds' reporting and disclosure regarding their liquidity profiles and liquidity risk management practices;
- Creating tools to assist mutual funds in allocating redemption costs more directly to those investors redeeming their shares;
- Requiring additional public disclosure and analysis of third-party financing sources, including lines of credit and interfund lending, and the events that trigger the use of such financing; and
- Implementing measures to mitigate liquidity and redemption risks applicable to collective investment funds and similar pooled investment vehicles offering daily redemptions.

Leverage. FSOC's review of leverage risk focused largely on hedge funds and was based on data reported on Form PF. According to the Statement, many hedge funds use relatively small amounts of leverage, and larger hedge funds tend to be more leveraged than smaller hedge funds, with some of the largest and most leveraged funds employing relative value, fixed-income arbitrage strategies and using repurchase agreements and derivatives to obtain leverage. FSOC found, according to the Statement, that while not an exact proxy for risk, leverage may present risks to financial stability when viewed in conjunction with other factors. Such risk, according to the Statement, is likely to be greater if: (a) higher levels of leverage are used; (b) borrowing counterparties are large, highly interconnected financial institutions; (c) margin requirements are lax and positions are not regularly marked to market; (d) the fund's underlying assets are less liquid and pricing sources are poor; or (e) other financial institutions with large positions are involved in similar trading strategies. Ultimately, FSOC concluded that its ability to fully evaluate leverage risk with respect to hedge funds, as well as proposed risk mitigants, such as proposed margin requirements and increased use of central clearing for derivatives, was limited at this time by insufficient data.

Given the need for further information and analysis, FSOC is creating an interagency working group to better understand leverage risk among hedge funds. Such group, according to the Statement, will:

- Use regulatory and supervisory data to evaluate the use of leverage in combination with other factors, including counterparty exposures, margining requirements, underlying assets and trading strategies, to asses potential risks to financial stability;
- Assess the sufficiency and accuracy of existing data and information, including Form PF, for evaluating risks to financial stability and consider how existing data might be enhanced to achieve this goal; and
- Consider potential enhancements to and the establishment of standards governing the current measures of leverage, including risk-based measures of leverage.

FSOC also noted its intention to monitor the effects on and implications for financial stability of any regulatory changes affecting registered funds, including (a) the SEC's proposed rule on the use of derivatives by registered investment companies, including mutual funds, exchange-traded funds and business development companies and (b) the proposed rule requiring registered investment advisers to provide annual data on the separately managed accounts they manage.

Operational Risk. In its review of operational risks within the asset management industry, FSOC generally noted that potential risks to financial stability will likely be greater when multiple asset managers rely on one or a small number of providers for certain services. Further, according to the Statement, the asset management industry continues to face new types of operational risk, such as cybersecurity risks. FSOC highlighted that asset management firms can try to mitigate operational risk generally through risk management programs and control environments.

According to the Statement, there is limited information available to enable FSOC and regulators to properly assess operational risk across the asset management industry. FSOC stated that it will continue to analyze operational risk, focusing on potential service provider risks based on the concentration of service providers, the level of outsourcing of particular services and the complexity of the infrastructure and activities supported by service providers. In addition, FSOC noted that it will consider whether operational disruptions in the asset management sector could potentially disrupt market functioning more broadly, and it will evaluate the current practices for managing these risks, such as business continuity and disaster recovery planning.

Securities Lending. FSOC noted that a thorough assessment of potential risks to financial stability from securities lending activities must include entities across the financial system and not solely in the asset management sector. According to the Statement, one potential risk from securities lending activity arises in connection with the reinvestment of cash collateral by securities lenders. According to FSOC, lenders that are not subject to regulatory limits on cash collateral reinvestment may invest such collateral in pooled investment vehicles with weighted average portfolio maturities significantly greater than the terms of their securities loans, resulting in liquidity and maturity disconnects that could pose a risk to financial stability in the event of widespread and unexpected borrower terminations of securities loans.

According to FSOC, comprehensive information on securities lending across the financial system is necessary but not yet available to conduct a full evaluation of potential risks. FSOC supported the recently completed joint securities lending data collection pilot program by the Office of Financial Research, the Federal Reserve and the SEC, and encouraged adoption of a rule requiring the permanent collection of such data, as well as an expansion of the scope to include more market participants involved in securities lending.

Resolvability and Transition Planning. According to the Statement, FSOC continues to examine potential risks to financial stability that may arise in a resolution or liquidation of an entity in the asset management field. FSOC highlighted that resolvability and transition challenges, such as the disruption or termination of a key service provider, complications from affiliate insolvencies, the liquidation and re-establishment of over-the-counter derivative positions and challenges associated with the transfer of foreign assets, could compound the risks arising from a stress or failure of an asset management firm or investment vehicle.

FSOC reiterated its recommendations with respect to liquidity and redemption risk and leverage risk with respect to a resolution or liquidation event of an asset manager or fund and more generally noted the benefit of advance planning by asset managers to mitigate risk in such situations.

SEC Chair Mary Jo White responded to the Statement by noting how FSOC's work complements the SEC's regulatory reforms with respect to the asset management industry. White briefly summarized the SEC's current initiatives in the asset management space, including enhanced data reporting, liquidity risk management and use of leverage, and noted upcoming proposals on transition planning and stress testing. In addition, White highlighted that although FSOC's update overlaps with certain of the SEC's proposed reforms, FSOC's Statement should not be read as an indication of the direction the SEC's final rules may take.

- **See a copy of Statement**
- **See a copy of Chair White's Response**

SEC Chair Mary Jo White Delivers Opening Remarks at the Compliance Outreach Program for Investment Companies and Investment Advisers

On April 19, 2016, SEC Chair Mary Jo White delivered the opening remarks to the SEC's 2016 Compliance Outreach Program for Investment Companies and Investment Advisers (the "**Program**"). White discussed the importance of compliance personnel and compliance programs in supporting the SEC's mission to protect investors and bolster capital formation.

White began by discussing the topics on the agenda for the Program, which included cybersecurity, liquidity management and the Division of Investment Management's rulemaking initiatives. She also noted the importance the SEC places on communication and information sharing between company compliance personnel and the SEC. She stressed the SEC's belief that compliance personnel must have an "unwavering commitment" to the best interests of investors in addition to a strong compliance program and culture of compliance.

White continued by noting the challenge the SEC faces in overseeing an investment management industry that has grown to nearly 12,000 registered advisers, 11,000 registered funds and 30,000 private funds representing $66.8 trillion in assets under management. According to White, the SEC relies on individual registrants' compliance programs to assist it, even as the Office of Compliance Inspections and Examinations ("**OCIE**") has expanded to 530 professionals. White also discussed new initiatives at OCIE to keep up with the industry's growth. According to White, OCIE is transitioning staff from broker-dealer exams to investment adviser exams with the goal of increasing the staffing of the investment adviser/investment company program by 20 percent. White also noted that more OCIE national priority exams are likely to be launched, which would include the review of investment advisers and investment companies that have not been examined before.

White went on to state that each registrant is responsible for maintaining its own effective compliance program, including the resolution of deficiencies, even if the registrant outsources its compliance function. She also emphasized that the compliance culture must permeate each level of the organization and that conflicts of interest must be fairly disclosed to investors. She explained that a goal of the National Examination Program is to support the development and implementation of strong compliance programs and cultures at registrant firms.

- **See a copy of the Speech**

Litigation

Second Circuit Rules that Criminal Liability for Violation of Section 206 of the Advisers Act Does Not Require Proof of Intent to Harm

On May 4, 2016, the Second Circuit of the U.S. Courts of Appeals (the "**Second Circuit**") affirmed the judgment of the U.S. District Court for the Southern District of New York (the "**District Court**") in the case of *United States v. Tagliaferri* in favor of the government. In reaching its decision, the Second Circuit held in its opinion (the "**Opinion**") that a criminal conviction premised on a violation of Section 206 of the Advisers Act ("**Section 206**") does not require proof of intent to harm.

According to the Opinion, James S. Tagliaferri (the "**Defendant**") founded Taurus Advisory Group in 1983 as a boutique investment advisory firm located in Stamford, Connecticut, which the Defendant relocated to the U.S. Virgin Islands and renamed as TAG Virgin Islands in late 2006. The Opinion noted that, starting in 2007, the Defendant began engaging in three categories of conduct that formed the bases of his convictions: First, the Defendant engaged in "kickback conduct" that included receiving more than $1.7 million in undisclosed fees from a company in which the Defendant invested his clients' assets, which the Defendant later attempted to recharacterize as consulting fees by sending post-receipt invoices to the company and asking an employee of such company to alter its records; second, the Defendant engaged in "cross-trade conduct," including the purchase of securities from one client's account with another client's assets, sometimes generating fees for himself, and without disclosing to either client that they were engaged in a cross-trade; and third, the Defendant engaged in "fake note conduct" with an investment in a company of over $5 million, which the Defendant first characterized as an equity investment, but later described as a loan in communications with the Defendant's clients. According to the Opinion, the Defendant created a number of fictitious "sub-notes" that he deposited in client accounts and engaged in cross-trades to pay off clients who demanded payment on the fictitious sub-notes.

According to the Opinion, the Defendant was indicted in 2014 and charged with investment adviser fraud under Section 206, securities fraud, wire fraud and multiple violations of the Travel Act. The Opinion noted that the Defendant acknowledged at trial that the fees posed a conflict of interest and should have been disclosed to his clients but argued that each investment made was based on his good faith belief that it was in the clients' best interests. The Opinion also noted that while admitting that the fictitious sub-notes were improper, the Defendant maintained that he had always "believed that he would be able to work things out so that his clients would not be harmed," and argued that Section 206 requires proof not only of "intent to deceive" but also of "intent to harm." According to the Opinion, the government and the District Court disagreed with this "intent to harm" requirement, and the jury ultimately convicted the Defendant on 12 of the 14 counts, including the count charging investment adviser fraud. In his appeal to the Second Circuit, the Defendant raised, among other challenges, that the District Court erred in declining to instruct the jury that the Defendant's intent to harm his clients was a necessary element of the investment adviser charge.

Section 206 makes it unlawful for any investment adviser to engage in (1) "any device, scheme, or artifice to defraud any client or prospective client," (2) "any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client," (3) a knowing sale or purchase of a security to or from a client, while acting on the behalf of someone other than the client (including oneself), without disclosing the transaction and obtaining the client's consent, or (4) "any act, practice, or course of business which is fraudulent, deceptive, or manipulative." The Opinion further noted that Section 209 of the Advisers Act ("**Section 209**") authorizes the SEC to enforce its provisions through, among other things, investigations, issuances of subpoenas, actions for injunctions in federal court and civil damages actions, while Section 217 of the Advisers Act ("**Section 217**") imposes criminal penalties on anyone who "willfully violates" the provisions of the Advisers Act or any SEC rule or regulation promulgated thereunder.

The Second Circuit stated that it was not persuaded by the Defendant's principal argument that, in a criminal prosecution under Section 217, Section 206 incorporates the common law requirement that intent to defraud includes both intent to deceive and intent to harm. The Second Circuit cited *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963), in which the Supreme Court held, in the context of determining the SEC's authority to seek a preliminary injunction for conduct violating the Advisers Act, that Section 206 departs from common law and does not "require proof of intent to injure and actual injury to clients." However, the Defendant argued that a criminal prosecution can be distinguished from equitable civil enforcement actions, such that the scope of Section 206 in actions for injunction under Section 209 reaches more broadly than it does in criminal prosecutions under Section 217.

According to the Opinion, the Second Circuit disagreed with this argument, noting that the only textual distinction between the civil and criminal enforcement mechanisms for Section 206 is the Advisers Act's requirement that a criminal defendant commit a violation "willfully," which the Supreme Court has held in prior cases generally to mean in a criminal statute "an act done with a bad purpose" or with "knowledge that [the] conduct was unlawful." The Second Circuit then drew a structural analogy between the four subsections of Section 206 (as delineated above) and the three subsections of Section 17(a) of the Securities Act of 1933 (the "**Securities Act**"): For Section 17(a), according to the Opinion, the Supreme Court previously concluded that while the language in the first subsection ("any device, scheme, or artifice to defraud") clearly demonstrated an intent on the part of Congress to proscribe only knowing or intentional misconduct, the other two subsections—which prohibited obtaining money or property "by means of any untrue statement of a material fact or any omission to state a material fact" and engaging "in any transaction, practice, or course of business which operates or would operate as a fraud or deceit," respectively—contained no indication that any intent was required.

Applying a similar textual analysis to Section 206, the Second Circuit determined that subsections (2) and (4) do not incorporate the full requirements of fraudulent intent at common law, since Section 206(2) is almost identical to Section 17(a)(3) of the Securities Act, and, for Section 206(4), the language "fraudulent, deceptive, or manipulative" had been construed to reach conduct motivated either by intent to defraud or intent to deceive in the context of other securities laws. According to the Second Circuit, neither willfully "engag[ing] in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client" nor willfully "engag[ing] in any act, practice, or course of business, which is fraudulent, deceptive, or manipulative" requires specific intent to harm, since the former is effect-focused, not intent-focused, and the latter requires, at a minimum, an intent to deceive. The Second Circuit therefore concluded that violating Section 206 willingly does not necessarily require intent to harm one's clients.

The Second Circuit further noted that this conclusion would be consistent with its prior holdings, since it had already applied *Capital Gains*' reasoning outside the context of equitable injunctions to a civil enforcement action for money damages. Also, the Second Circuit noted, as the Supreme Court previously concluded in *Aaron v. SEC*, 446 U.S. 680 (1980), scienter was an element of Section 10(b) of the Securities Exchange Act of 1934 (the "**Exchange Act**") but not Section 206 precisely because the latter had legislative history, statutory text, and the context of a fiduciary relationship indicating that intent was not required, and further, as the Second Circuit had just recently made clear, even Section 10(b) does not require intent to harm. The Opinion thus stated that it would be inconsistent with *Aaron*'s discussion to conclude that Section 206 did require intent to harm.

In summary, the Second Circuit found that it would be inconsistent with the text of Section 206 and the congressional purpose motivating it to require specific intent to harm, especially given the special context of a fiduciary relationship. According to the Second Circuit, the willfulness mental state required by Section 217 would ensure that criminal penalties are limited to cases in which the Government is able to prove that, at minimum, "the defendant acted with knowledge that his conduct was unlawful." The Second Circuit thus held that because the wrongfulness of Section 206 violations derives from their deceptiveness, proof that the Defendant intended to deceive his clients was sufficient to establish the requisite mens rea for guilt.

- **See a copy of the Opinion**

SEC Charges Accounting Firm with Conducting Deficient Surprise Exams

On April 29, 2016, the SEC issued an order (the "**Order**") agreeing to settle charges with accounting firm Santos, Postal, & Co. P.C. ("**SPC**") and one of its partners (the "**Partner**") for allegedly performing inadequate surprise examinations of SFX Financial Advisory Management Enterprises, Inc. ("**SFX**") under Section 206(4) of the Investment Advisers Act and Rule 206(4)-2 thereunder (the "**Custody Rule**"). The Order relates to audits from 2010 and 2011 that were conducted while SFX's president (the "**President**") misappropriated money from accounts belonging to professional athletes. Please see the **July 14, 2015 Investment Management Regulatory Update** for further discussion regarding the proceedings against SFX. SPC and the Partner consented to the Order without admitting or denying the SEC's findings.

According to the Order, from 2010 to 2011, SPC completed three reports for SFX which were filed with the SEC on Forms ADV-E. The Order alleged that two of SPC's reports regarding its examinations of SFX contained untrue statements of material fact, in violation of Section 207 of the Advisers Act, relating to (i) a statement that SPC had confirmed with SFX's clients contributions to and withdrawals from client accounts (when, according to the SEC, it had not) and (ii) a statement that a qualified custodian had maintained all client funds and securities (when, according to the SEC, SPC and the Partner knew at the time of such statement that the President had misappropriated certain client funds, and therefore that not all client funds were maintained with a qualified custodian).

According to the Order, as a result of the actions described above, SPC and the Partner were found to have engaged in improper professional conduct as defined in Section 4C(b) of the Exchange Act and Rule 102(e)(1)(iv) of the SEC's Rules of Practice. Additionally, the SEC alleged that SPC and the Partner violated Section 207 of the Advisers Act, which generally prohibits willfully making any untrue statement in any registration, application or report filed with the SEC.

The SEC ordered that SPC be suspended from appearing before the SEC as an accountant, including not participating in the financial reporting or audits of public companies, and be permitted to apply for reinstatement after one year. SPC was also ordered to pay a disgorgement of $25,800 of profits from performing the surprise audits, as well as a $15,000 penalty. The SEC ordered that the Partner (i) be suspended from appearing before the SEC as an accountant (with permission to apply for reinstatement after five years) and (ii) pay a separate $15,000 penalty.

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

Davis Polk

- See a copy of the SEC 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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