

[edu/2018/05/23/congress-increases-pressure-on-proxy-advisory-firms/](https://www.reed.senate.gov/news/releases/as-sec-evaluates-proxy-process-us-senators-introduce-corporate-governance-fairness-act). While others for different, but related, reasons believe that appropriate regulation is imperative. *See* Corporate Governance Fairness Act, *infra* note 12.

<sup>12</sup>*See* “As SEC Evaluates Proxy Process, U.S. Senators Introduce Corporate Governance Fairness Act” (Nov. 14, 2018) (“Corporate Governance Fairness Act”), *available at* <https://www.reed.senate.gov/news/releases/as-sec-evaluates-proxy-process-us-senators-introduce-corporate-governance-fairness-act> (discussing the introduction of the Corporate Governance Fairness Act, which is designed to “help ensure that investors may confidently rely on the advice of proxy advisory firms by requiring the U.S. Securities and Exchange Commission (SEC) to regulate all major proxy advisory firms under the Investment Advisers Act (IAA)”).

<sup>13</sup>*See* Corporate Governance Fairness Act, *supra* note 12.

<sup>14</sup>*See* NYSE Rule 452 and Section 952 of the Dodd-Frank Wall Street Reform Act of 2010.

<sup>15</sup>Regulation Best Interest (Proposed Rule), File No. S7-07-18 (Apr. 18, 2018).

<sup>16</sup>*See* Exchange Act Release No. 34-40018 (May 21, 1998) (adopting), where the Commission increased the dollar value of a company’s voting shares that a shareholder must own in order to be eligible to submit a shareholder proposal but decided not to adopt the proposed increase to resubmission thresholds.

<sup>17</sup>Staff Legal Bulletin No. 14I (CF) (Nov. 1, 2017).

<sup>18</sup>According to the ISS website: “For determining which companies are eligible for a draft review, ISS generally uses the S&P 500 constituent list as of January 31st for annual meetings occurring during the following proxy season.” *Available at* <https://www.issgovernance.com/iss-draft-review-process-u-s-issuers/>.

<sup>19</sup>Some guidelines appear arbitrary, or at least untethered to legal requirements or metrics. For example, ISS’ guidelines state that it generally favors voting for resolutions that require

disclosures on Climate Change/Greenhouse Gas Emissions without mentioning any legal requirements on companies to do so, value justifications, or thresholds of materiality to investors. *See, e.g.*, ISS’ United States Proxy Voting Guidelines, at 57 (guidelines generally favor voting for resolutions requiring disclosures on Climate Change/Greenhouse Gas (GHG) Emissions with no mention of whether this information is material to investors). Other guidelines I have seen actually appear to *undermine* legal authority. Glass Lewis’ 2019 Proxy Paper Guidelines state that it will make note of instances where a public company has successfully petitioned the SEC to exclude shareholder proposals and potentially recommend against members of the company’s governance committee. *See, e.g.*, Glass Lewis’ 2019 Proxy Paper Guidelines, at 29 (“Glass Lewis will make note of instances where a company has successfully petitioned the SEC to exclude shareholder proposals. If after review we believe that the exclusion of a shareholder proposal is detrimental to shareholders, we may, in certain very limited circumstances, recommend against members of the governance committee.”).

## SEC/SRO UPDATE:

### OCIE RELEASES EXAMINATION INITIATIVES FOR REGISTERED INVESTMENT COMPANIES; OCIE ISSUES RISK ALERT RELATED TO THE CASH SOLICITATION RULE FOR INVESTMENT ADVISERS; SEC CRACKS DOWN ON UNREGISTERED COIN OFFERINGS

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### OCIE Releases Examination Initiatives for Registered Investment Companies

On November 8, the Securities and Exchange Commission's (SEC) Office of Compliance Inspections and Examinations (OCIE) released a Risk Alert about a series of examination initiatives focused on mutual funds and exchange-traded funds (ETFs) in order to "assess industry practices and regulatory compliance in certain areas that may have an impact on retail investors."<sup>1</sup>

In the Risk Alert, OCIE identified six focus areas for funds and advisers, including:

- Index funds that track custom-built indexes;
- Smaller ETFs and ETFs with little secondary market trading volume;
- Mutual funds with higher allocations to certain securitized assets;
- Funds with aberrational underperformance relative to their peer groups;
- Advisers relatively new to managing mutual funds; and
- Advisers who provide advice to both mutual funds and private funds that have similar strategies and are managed by the same portfolio managers.

OCIE indicated that although the examination scope and focus area will be tailored to address the business practices, risks, and conflicts ap-

plicable to each topic, the staff will generally assess:

- Policies and procedures of the funds and their advisers, to validate that they are designed to address risks and conflicts, including funds' boards oversight of the compliance program;
- Disclosures by funds to investors in their prospectuses and other filings and shareholder communications, and by advisers to the funds' boards, regarding risks and conflicts; and
- Deliberative processes utilized by funds, their advisers, and their boards exercising oversight, particularly when assessing practices and controls related to risks and conflicts, including disclosures, portfolio management compliance, and fund governance.

OCIE also indicated that while these are the primary focus areas for the initiatives, the staff may select additional topics based on operational and other risks identified during the examinations.

### OCIE Issues Risk Alert Related to the Cash Solicitation Rule for Investment Advisers

On October 31, OCIE issued a Risk Alert to provide investment advisers, investors, and other market participants with information concerning the most common deficiencies the staff had cited relating to Rule 206(4)-3 (the "Cash Solicitation Rule") under the Investment Advisers Act of 1940.<sup>2</sup>

The Risk Alert included observations by

OCIE staff and was “intended to assist investment advisers in identifying potential issues and adopting and implementing effective compliance programs.”

Investment advisers required to be registered under the Advisers Act are generally prohibited from paying a cash fee, directly or indirectly, to any person who solicits clients for the adviser unless the arrangement complies with several conditions. Among other things, the cash fee must be paid pursuant to a written agreement to which the adviser is a party. The solicitor may not be a person subject to certain disqualifications specified in the Cash Solicitation Rule.

There are additional requirements when the solicitor is not a partner, officer, director, or employee of the adviser or of an entity that controls, is controlled by, or is under common control with, the adviser (a “third-party solicitor”), including:

- the solicitation agreement must contain certain specified provisions (*e.g.*, a description of the solicitation activities and compensation to be received);
- the solicitation agreement must require that, at the time of any solicitation activities, the solicitor provide the prospective client with a copy of (i) the adviser’s brochure pursuant to Advisers Act Rule 204-3; and (ii) a separate, written disclosure document containing required information that highlights the solicitor’s financial interest in the client’s choice of an adviser;
- the adviser must receive from the client, before or at the time of entering into any

written or oral agreement with the client, a signed and dated acknowledgment that the client received the adviser brochure and the solicitor disclosure document; and

- the adviser must make a bona fide effort to ascertain whether the solicitor has complied with the solicitation agreement and must have a reasonable basis for believing that the solicitor has so complied.

Some of the most commonly cited deficiencies include:

- *Solicitor disclosure documents*—OCIE staff observed advisers whose third-party solicitors did not provide solicitor disclosure documents to prospective clients or provided solicitor disclosure documents that did not contain all the information required by the Cash Solicitation Rule.
- *Client acknowledgements*—OCIE staff observed advisers that did not receive in a timely manner a signed and dated client acknowledgement of receipt of the adviser brochure and the solicitor disclosure document. Staff also observed advisers that received client acknowledgements, but such client acknowledgements were undated or dated after the clients had entered into an investment advisory contract.
- *Solicitation agreements*—OCIE staff observed advisers that paid cash fees to a solicitor without a solicitation agreement in effect or pursuant to an agreement that did not contain certain specific provisions.
- *Bona fide efforts to ascertain solicitor compliance*—OCIE staff observed advis-

ers that did not make a bona fide effort to ascertain whether third-party solicitors complied with solicitation agreements and appeared to not have a reasonable basis for believing that the third-party solicitors so complied. For example, staff observed advisers that were unable to describe any efforts they took to confirm compliance with solicitation agreements.

### SEC Cracks Down on Unregistered Coin Offerings

On November 16, the SEC announced its first ever civil penalty against issuers for failing to register initial coin offerings (ICOs). This action was part of a larger series of cases in which the agency has cracked down on alleged abuses in the digital currency industry.

According to the SEC's announcement, CarrierEQ Inc., known as Airfox, and Paragon Coin Inc., both cryptocurrency startups, conducted ICOs in 2017 after the SEC warned in its DAO Report of Investigation that ICOs can be viewed as securities offerings.<sup>3</sup> Airfox raised approximately \$15 million in its ICO to finance an app for users in emerging markets to earn and exchange tokens. Paragon raised approximately \$12 million in its ICO to develop and implement its business plan to add blockchain technology to the cannabis industry. According to the SEC, neither Airfox nor Paragon registered their ICOs pursuant to the federal securities laws, nor did they qualify for an exemption to the registration requirements. According to the SEC, both startups have agreed to compensate allegedly harmed ICO investors, pay penalties, register their tokens as securities pursuant to the Securities Exchange Act of 1934, and file periodic reports with the SEC for at least one year.

The Airfox and Paragon cases follow the SEC's first non-fraud ICO registration case last year against crypto startup, Munchee, Inc. The SEC did not impose a penalty in that case, however, because Munchee stopped its unregistered offering before delivering any tokens and promptly returned the offering proceeds to its investors.

In addition, the announced settlement with Airfox and Paragon came a week after the SEC announced another "first," settling charges that another crypto firm, EtherDelta, was operating as an unregistered national securities exchange.<sup>4</sup> According to the SEC's order, EtherDelta provided a marketplace for bringing together buyers and sellers for digital asset securities through the combined use of an order book, a website that displayed orders, and a "smart contract" run on the Ethereum blockchain. EtherDelta's smart contract was coded to validate the order messages, confirm the terms and conditions of orders, execute paired orders, and direct the distributed ledger to be updated to reflect a trade.

These cases underscore the SEC's insistence that the relatively new digital currency industry needs to follow traditional securities rules. "We have made it clear that companies that issue securities through ICOs are required to comply with existing statutes and rules governing the registration of securities," Stephanie Avakian, the Co-Director of the SEC's Enforcement Division, said in a statement announcing the Airfox and Paragon settlements. "These cases tell those who are considering taking similar actions that we continue to be on the lookout for violations of the federal securities laws with respect to digital assets."

**ENDNOTES:**

<sup>1</sup>Office of Compliance Inspections and Examinations, Securities and Exchange Commission, “Risk-Based Examination Initiatives Focused on Registered Investment Companies” (Nov. 8, 2018), *available at* <https://www.sec.gov/ocie/announcement/ocie-risk-alert-registered-investment-company-initiative>.

<sup>2</sup>Office of Compliance Inspections and Examinations, Securities and Exchange Commission, “Risk Alert: Investment Adviser Compliance Issues Related to the Cash Solicitation Rule” (Oct. 30, 2018), *available at* <https://www.sec.gov/ocie/announcement/risk-alert-investment-adviser-compliance-issues-related-cash-solicitation-rule>.

<sup>3</sup>See SEC Rel. No. 2018-264 (November 16, 2018), *available at* <https://www.sec.gov/news/press-release/2018-264>; See also SEC, Release No. 81207, Release No. 81207, *available at* <https://www.sec.gov/litigation/investreport/34-81207.pdf>.

<sup>4</sup>See SEC Rel. No. 2018-258 (November 8, 2018), *available at* <https://www.sec.gov/news/press-release/2018-258>.