Investment Management Regulatory Update

April 30, 2020

COVID-19 Update

- SEC Division of Investment Management Coronavirus (COVID-19) Response FAQs
- SEC Provides Temporary, Conditional Relief for Business Development Companies Making Investments in Small and Medium-Sized Businesses

Rules and Regulations

- SEC Proposes to Modernize Framework for Fund Valuation Practices
- SEC Adopts Offering Reforms for Business Development Companies and Registered Closed-End Funds
- SEC Adopts Rule Permitting Simplified Prospectus Summaries for Variable Annuities and Variable Life Insurance Contracts

Industry Update

- OCIE Publishes Risk Alerts Providing Advance Information Regarding Inspections for Compliance with Regulation Best Interest and Form CRS

Litigation

- SEC Settles with Investment Adviser for Alleged Undisclosed Conflicts of Interest Regarding In-House Operations Fees
- SEC Settles with Investment Adviser for Alleged Advertising Omissions
- SEC Obtains Partial Summary Judgment Against Investment Adviser and Principal

COVID-19 Update

In addition to the items below, please refer to Davis Polk's **"Coronavirus Updates"** webpage for additional content related to the outbreak.

SEC Division of Investment Management Coronavirus (COVID-19) Response FAQs

On April 14, 2020, Division of Investment Management staff issued FAQs regarding Securities and Exchange Commission ("**SEC**") responses to COVID-19-related issues faced by funds and advisers. Among other things, the staff highlighted recent exemptive orders and no-action relief issued by the SEC and its staff to address such issues. The staff also noted that the SEC's Office of Compliance Inspections and Examinations ("**OCIE**") stated that reliance on such regulatory relief would not be considered a risk factor in determining whether OCIE commences an examination, and generally encouraged registrants to use available regulatory relief as needed. The FAQs also included links to additional staff responses to COVID-19-related questions such as:

- whether an adviser is required to update Form ADV Item 1.F in order to list the temporary teleworking addresses of its employees;

  - the SEC staff's response stated that as long as the employees are temporarily teleworking as part of the adviser's business continuity plan due to circumstances related to COVID-19, it would not recommend enforcement action if the adviser does not update its Form ADV Item 1.F to list the temporary teleworking addresses.
- implications under the Custody Rule of the inadvertent receipt of client securities when an adviser's personnel may be unable to access mail or deliveries at an office location due to the adviser's business continuity plan in response to COVID-19;
  - the SEC staff's response stated that in such circumstance, it would not consider the adviser to have received client assets at that office location until the adviser's personnel are able to access the mail or deliveries at that office location.
- compliance with the Custody Rule when a pooled investment vehicle fails to distribute its audited financial statements within 120 days after the end of its fiscal year due to certain unforeseeable circumstances;
  - the SEC staff's response stated that it would not recommend enforcement action against an adviser that is relying on Rule 206(4)-2(b)(4) and that reasonably believed that the pooled investment vehicle's audited financial statements would be distributed within the required deadlines, but failed to have them distributed in time under certain unforeseeable circumstances.
- inability to complete surprise examinations required by the Custody Rule due to logistical disruptions related to COVID-19;
  - the SEC staff's response stated that it would not recommend enforcement action against an adviser that reasonably believed that the surprise examination and Form ADV-E filing would be completed by the required deadline, but failed to do so due to logistical disruptions related to COVID-19, as long as the independent public accountant completes the filing as soon as practicable, but not later than 45 days after the original due date.
- Custody Rule compliance for certain privately issued securities that are evidenced by physical certificates, but cannot be kept with a qualified custodian due to the COVID-19 pandemic.
  - the SEC staff's response stated that during the qualified custodian's closure due to COVID-19, until such time as physical certificates can reasonably be placed with a qualified custodian or similar securities can reasonably be issued in compliance with the privately offered securities exception, it would not recommend enforcement action if an adviser does not maintain the certificates with a qualified custodian, provided that: (1) the physical certificates can only be used to effect a transfer or to otherwise facilitate a change in beneficial ownership of the security with the prior consent of the issuer or holders of the outstanding securities of the issuer; (2) ownership of the security is recorded on the books of the issuer or its transfer agent (or person performing similar functions) in the name of the client; (3) the physical certificates contain a legend restricting transfer; (4) the physical certificates are appropriately safeguarded by the adviser and can be replaced upon loss or destruction; and (5) the adviser makes and keeps (in accordance with Rule 204-2) a record of the custodian's closure.

- **See a copy of the FAQs**

SEC Provides Temporary, Conditional Relief for Business Development Companies Making Investments in Small and Medium-Sized Businesses

On April 8, 2020, the SEC announced that it was providing temporary, conditional exemptive relief for business development companies ("**BDCs**") to make additional investments in small and medium-sized businesses ("**portfolio companies**") in response to the effects of COVID-19 on the operations of such businesses. The temporary relief allows additional flexibility for BDCs (i) to issue and sell senior securities and (ii) to participate in certain joint transactions that would otherwise be prohibited by Section 57(a)(4) of the Investment Company Act of 1940, as amended ("**Investment Company Act**") and Rule 17d-1 thereunder. The SEC's order providing the relief (the "**Order**") stated that BDCs were created "to provide capital to smaller domestic operating companies that otherwise may not be able to readily access the capital markets" and that the SEC recognizes that many BDCs "may face challenges absent these exemptions" in providing such capital due to the effects of COVID-19 on their operations.

The Order continued by indicating that BDCs may face such challenges if "unable to satisfy the asset coverage requirements under the Investment Company Act due to temporary markdowns in the value of the loans to such portfolio companies" or if certain affiliates of BDCs are prohibited from participating in additional investments in BDCs' portfolio companies due to the restrictions in BDCs' existing exemptive orders permitting co-investments. The SEC found that the Order was "necessary and appropriate in order for BDCs to continue providing credit support to portfolio companies impacted by COVID-19." The time period for the exemptions provided by the Order is from April 8, 2020 to the earlier of December 31, 2020 and the date by which the BDC ceases to rely on the Order (the "**Exemption Period**").

In the press release announcing the Order, SEC Chairman Jay Clayton remarked that the Order's "targeted action will enable BDCs to provide their businesses with additional financial support during these times" and that the Order's conditions "are designed to ensure that this temporary relief will both protect and benefit investors in the BDCs."

Issuance and Sale of Senior Securities by BDCs

The Order provides temporary relief from certain asset coverage requirements applicable to BDCs when issuing or selling a senior security that represents indebtedness or is a stock, including the requirement to "determine asset coverage on the basis of values calculated as of a time within forty-eight hours. . . next preceding the time of such determination," subject to certain conditions. The temporary relief allows a BDC to meet the asset coverage ratio required under Section 18(a), as modified by Section 61(a) of the Investment Company Act for BDCs, using an Adjusted Asset Coverage Ratio calculated as follows:

- Calculate the BDC's adjusted portfolio value (the "**Adjusted Portfolio Value**") using values calculated as of December 31, 2019 for securities (i) that the BDC held at December 31, 2019, (ii) that the BDC continues to hold at the time of the issuance or sale of the senior security and (iii) for which the BDC is not recognizing a realized loss; and
- Calculate the BDC's Adjusted Asset Coverage Ratio by reducing its asset coverage ratio (calculated using the Adjusted Portfolio Value) by 25% of the difference between (i) the asset coverage ratio calculated using the Adjusted Portfolio Value and (ii) the asset coverage ratio calculated in accordance with Section 18(b).

Pursuant to the Order, the temporary relief is also conditioned on (1) the BDC making an election to rely on the exemption on Form 8-K, (2) certain limitations on initial investments in portfolio companies, (3) approval of reliance on the Order by the board of directors or trustees of the BDC (the "**Board**"), (4) approval of each issuance of senior securities covered by the Order by the Board, based on certain certifications from the BDC's investment adviser and advice from an independent evaluator regarding the terms and conditions of the proposed issuance, (5) regular reporting to the Board on the BDC's efforts to comply with the asset coverage requirements under Section 18, as modified under Section 61 for BDCs, by the expiration of the Exemption Period, and disclosure on Form 8-K in the event the BDC does not comply with such requirements by the expiration of the Exemption Period; (6) certain recordkeeping requirements regarding related Board materials and (7) certain prohibitions on compensation of affiliated persons of the BDC from portfolio companies in which the BDC invests during the Exemption Period.

Expansion of Relief for BDCs with Existing Co-Investment Orders

The Order also permitted additional flexibility for any BDC to which an SEC order permitting co-investment transactions in portfolio companies with certain affiliated persons is currently applicable. Such flexibility includes permission to participate in a Follow-On Investment with one or more Regulated Funds and/or Affiliated Funds (each term with the meaning ascribed to it in the BDC's existing co-investment order or the meaning ascribed to the substantially similar term used in the BDC's existing co-investment order), subject to certain conditions, including Board oversight.

- **See a copy of the Order**
- **See a copy of the press release announcing the Order**

Rules and Regulations

SEC Proposes to Modernize Framework for Fund Valuation Practices

On April 21, 2020, the SEC proposed new Rule 2a-5 to clarify the requirements for a registered fund board's good faith determination of the fair value of the fund's investments under Section 2(a)(41) of the Investment Company Act. According to the press release announcing the proposal, Rule 2a-5 is designed to address market developments in registered fund valuation practices, "including an increase in the variety of asset classes held by funds and an increase in both the volume and type of data used in valuation determinations." The proposed rule also recognizes the important role and expertise provided by registered fund advisers in the valuation process. Notably, proposed Rule 2a-5 permits a fund board to assign the valuation functions described below to the fund's investment adviser, subject to:

- Board oversight of the adviser;
- Periodic and prompt reporting to the board;
- Clear specification of responsibilities and reasonable segregation of duties among the adviser's personnel; and
- Maintenance of additional records relevant to the assignment to the adviser.

According to the press release, under proposed Rule 2a-5, good faith fair value determinations with respect to a registered fund would require performance of certain functions, including:

- Periodically assessing and managing material risks associated with fair value determinations, including material conflicts of interest;
- Selecting, applying and testing fair value methodologies; and
- Overseeing and evaluating any pricing services used.

Proposed Rule 2a-5 would also require adoption and implementation of written policies and procedures addressing fair value determination and maintenance of certain records.

Davis Polk will publish a client alert discussing the proposal shortly.

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

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

On April 8, 2020, the SEC voted to adopt rule amendments (the "**Amendments**") to implement certain provisions of the Small Business Credit Availability Act and the Economic Growth, Regulatory Relief, and Consumer Protection Act impacting business development companies and registered closed-end funds (the "**Impacted Funds**").

According to the adopting release for the Amendments (the "**Adopting Release**"), the SEC adopted the Amendments to modify the registration, communications and offering processes for Impacted Funds, and to allow Impacted Funds to use certain streamlined securities offering rules that are already available to operating companies.

Specifically, the Adopting Release notes that the Amendments will permit Impacted Funds to use a more abbreviated shelf offering process and short-form registration statement if the fund meets certain requirements. The Amendments will also allow Impacted Funds to qualify for well-known seasoned issuer ("**WKSI**") status and benefit from the same flexibility available to operating companies that qualify as WKSIs. Additionally, the Amendments will allow for Impacted Funds to use certain communication rules currently available to operating companies, including the use of a "free writing prospectus," and allow Impacted Funds to satisfy their final prospectus delivery obligations by filing the prospectuses with the SEC. The Amendments also create a new method for interval funds, a type of closed-end fund that offers to repurchase a portion of its shares at regular intervals, and certain exchange-traded products not registered under the Investment Company Act, to pay registration fees in a manner similar to the way that mutual funds and exchange-traded funds pay registration fees. Additionally, the Amendments expand the scope of Rule 486 under the Securities Act of 1933, as amended (the "**Securities Act**"), which permits funds to make certain changes to their registration statements on an immediately-effective basis or on an automatically effective basis a set period of time after filing, to include closed-end funds that do not operate as interval funds. The Amendments also impose certain structured data requirements and periodic reporting requirements on Impacted Funds similar to those existing for mutual funds and exchange-traded funds. Finally, the Amendments eliminate the requirement for Impacted Funds to provide new purchasers with copies of all previously filed materials that have been incorporated by reference into a registration statement, but would allow Impacted Funds to make those documents available on a website instead.

The Amendments will become effective on August 1, 2020, except for the amendments related to registration fee payments by interval funds and exchange-traded products, which will become effective on August 1, 2021. According to the press release announcing the Amendments, the SEC is adopting the following compliance dates for the requirements under the Amendments:

- August 1, 2021: the requirement for registered closed-end funds to provide management's discussion of fund performance in their annual reports to shareholders.
- August 1, 2022: Inline eXtensible Business Reporting Language ("**Inline XBRL**") structured data reporting requirements for financial statement, registration statement information, and prospectus information for affected funds that are eligible to file a short-form registration statement. For all other affected funds subject to these structured data reporting requirements, the compliance date is February 1, 2023.
- February 1, 2022: the requirement that Form 24F-2 filers (including existing filers) file reports on Form 24F-2 in an XML structured data format.
- **See a copy of the Adopting Release**

SEC Adopts Rule Permitting Simplified Prospectus Summaries for Variable Annuities and Variable Life Insurance Contracts

The SEC adopted a new rule ("**Rule 498A**") under the Securities Act, effective July 1, 2020, which will allow variable annuity providers and variable life insurance providers to satisfy their disclosure requirements by providing investors with summary prospectuses, so long as more detailed disclosures are available online or provided in paper format upon request. According to the SEC's adopting release, the approach under the new rule contemplates the use of two types of summary prospectuses: an "initial summary prospectus" to be provided to new investors, and an "updating summary prospectus" to be provided to existing investors. Each type of summary prospectus uses a layered disclosure approach designed to provide investors with key information relating to the contract's terms, benefits and risks in a concise and more reader-friendly presentation, with website addresses or hyperlinks to more detailed information posted online and delivered electronically or in paper format on request. Rule 498A is designed to generally model the framework for mutual fund prospectus summaries adopted by the SEC in 2009.

In addition to adopting Rule 498A, the SEC also adopted (i) amendments to the registration forms for variable annuities and variable life insurance contracts that, according to the SEC, enhance the disclosures to investors for such contracts and implement the prospectus summary framework, (ii) a requirement to use the Inline XBRL format for certain required disclosures and (iii) certain technical and conforming amendments to SEC rules and forms, including rescission of certain related rules and forms, to reflect the new prospectus summary framework.

According to the press release announcing the new rule, the SEC is adopting the following compliance and other dates:

- July 1, 2020: a registrant can rely on Rule 498A to satisfy its obligations to deliver a variable contract's statutory prospectus by delivering a summary prospectus if the registrant is also in compliance with the amendments to Forms N-3, N-4 or N-6.
- January 1, 2022: all initial registration statements on Forms N-3, N-4 and N-6, and all post-effective amendments that are annual updates to effective registration statements on these forms, must comply with the rule and form amendments.
- January 1, 2023, registrants must submit to the SEC certain specified disclosures in Inline XBRL.
- **See a copy of the Adopting Release**

Industry Update

OCIE Publishes Risk Alerts Providing Advance Information Regarding Inspections for Compliance with Regulation Best Interest and Form CRS

On April 7, 2020, the OCIE issued two risk alerts (the "**Risk Alerts**"): (1) Examinations that Focus on Compliance with Regulation Best Interest (the "**Best Interest Risk Alert**") and (2) Examinations that Focus on Compliance with Form CRS (the "**Form CRS Risk Alert**"). According to the press release accompanying the Risk Alerts (the "**Release**"), the Risk Alerts "provide broker-dealers and investment advisers with advance information about the expected scope and content of the initial examinations for compliance with Regulation Best Interest and Form CRS." According to the Release, Regulation Best Interest and Form CRS are important components of a broader effort to enhance the quality and transparency of retail investors' relationships with broker-dealers and investment advisers. As noted in the Release, the compliance date for both Regulation Best Interest and Form CRS is June 30, 2020.

The Best Interest Risk Alert

The Best Interest Risk Alert focused on providing broker-dealers with information about the scope and content of initial examinations after the June 30, 2020 compliance date. According to the Best Interest Risk Alert, Regulation Best Interest establishes a new standard of conduct under the Securities Exchange Act of 1934 for broker-dealers and associated persons of broker-dealers. For example, when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer (a "**Recommendation**"), a broker-dealer must act in the best interest of such retail customer at the time the Recommendation is made, without placing its own financial or other interest ahead of the retail customer's interest. According to the Release, such obligation is satisfied only if a broker-dealer complies with the following four "component obligations": (i) a disclosure obligation, (ii) a care obligation, (iii) a conflict of interest obligation and (iv) a compliance obligation.

According to the Best Interest Risk Alert, OCIE will begin examinations to assess implementation of Regulation Best Interest after June 30, 2020, and the examinations will be designed primarily to evaluate compliance with Regulation Best Interest, including whether firms have established policies and procedures reasonably designed to achieve compliance.

In the Best Interest Risk Alert, the SEC staff identified areas that initial examinations may focus on, based on the four component obligations:

<u>Disclosure Obligation</u>

- <u>Disclosure Obligation</u>: According to the Best Interest Risk Alert, the disclosure obligation requires a broker-dealer to provide a retail customer full and fair disclosure, in writing and prior to or at the time of Recommendation, of the following information:
  - all material facts relating to the scope and terms of the broker-dealer's relationship with the retail customer; and
  - all material facts relating to conflicts of interest that are associated with the Recommendation.
- <u>Specific Disclosures</u>: According to the Best Interest Risk Alert, SEC staff (the "**Staff**") may assess how the broker-dealer firm has met its obligation to disclose material facts relating to the scope and terms of the relationship with the retail customer, including (i) the capacity in which the recommendation is being made, (ii) material fees and costs that apply to the retail customer's transactions, holdings and accounts and (iii) material limitations on the securities or investment strategies involving securities that may be recommended to the retail customer.
- <u>Document Requests</u>: To assess compliance with this obligation, Staff may review the content of the disclosures, and other broker-dealer records, to assess whether the disclosures provide the required information to retail customers and to assess the timing of the disclosures. According to the Best Interest Risk Alert, Staff may review:
  - "Schedules of fees and charges assessed against retail customers and disclosures regarding such fees and charges, including disclosures regarding the fees and costs related to services and investments that retail customers will pay or incur directly and indirectly (e.g., custodian fees, account maintenance fees, fees related to mutual funds and variable annuities, and other transactional fees and product-level fees);
  - The broker-dealer's compensation methods for registered personnel, including (i) compensation associated with recommendations to retail customers, (ii) sources and types of compensation (e.g., direct payments by an investor or payments by a product sponsor) and (iii) related conflicts of interest (e.g., conflicts associated with recommending proprietary products or with receiving payments for inclusion on a product menu);

  - Disclosures related to monitoring of retail customers' accounts;
  - Disclosures on material limitations on accounts or services recommended to retail customers; and
  - Lists of proprietary products sold to retail customers."

Care Obligation

- Care Obligation: According to the Best Interest Risk Alert, the care obligation requires a broker-dealer to exercise reasonable diligence, care and skill when making Recommendations to retail customers, including understanding potential risks, rewards and costs associated with the Recommendation and then considering such factors in light of the retail customer's investment profile.
- Document Requests: To assess compliance with this obligation, according to the Best Interest Risk Alert, Staff may review:
  - "Information collected from retail customers to develop their investment profiles (including any new account forms, correspondence and any agreements the customer has with the broker-dealer).
  - The broker-dealer's process for having a reasonable basis to believe that the recommendations are in the best interest of the retail customer (which may include, e.g., any process for establishing, understanding and implementing the scope of reasonably available alternatives when making a recommendation).
    - The factors the broker-dealer considers to assess the potential risks, rewards and costs of the recommendations in light of the retail customer's investment profile.
    - The broker-dealer's process for having a reasonable basis to believe that it does not place the financial or other interest of the broker-dealer ahead of the interest of the retail customer.
  - How the broker-dealer makes recommendations related to significant investment decisions, such as rollovers and account recommendations, and how the broker-dealer has a reasonable basis to believe that such investment strategies are in a retail customer's best interest.
  - How the broker-dealer makes recommendations related to more complex, risky or expensive products and how the broker-dealer has a reasonable basis to believe that such investments are in a retail customer's best interest."

Conflict of Interest Obligation

- Conflict of Interest: According to the Best Interest Risk Alert, the conflict of interest obligation requires a broker-dealer to establish, maintain, and enforce written policies and procedures that are reasonably designed to address conflicts of interest associated with its Recommendations to retail customers.
- Document Requests: To determine compliance with this obligation, according to the Best Interest Risk Alert, Staff may review the broker-dealer's policies and procedures to determine:
  - "Whether and how the policies and procedures address the following, as required by Regulation Best Interest:
    - conflicts that create an incentive for an associated person to place its interest or the interest of a broker-dealer ahead of the interest of the retail customer;

        - conflicts associated with material limitations (e.g., a limited product menu, offering only proprietary products, or products with third-party arrangements) on the securities or investment strategies involving securities that may be recommended to a retail customer; and
        - the elimination of the following conflicts: sales contests, sales quotas, bonuses and noncash compensation based on the sale of specific securities or specific types of securities within a limited period of time.
    - How the policies and procedures establish a structure for identifying the conflicts that the broker-dealer or its associated person may face. Staff may request documentation identifying any and all conflicts associated with the broker-dealer's recommendations.
    - How the policies and procedures establish a structure to identify and assess conflicts in the broker-dealer's business as it evolves. Staff may request to see all policies and procedures in place during the scope period of the examination.
    - How the policies and procedures provide for disclosure of conflicts and what conflicts are disclosed.
    - How the policies and procedures provide for mitigation or elimination of conflicts and what conflicts are mitigated or eliminated."

<u>Compliance Obligation</u>

- <u>Compliance Obligation</u>: According to the Best Interest Risk Alert, the compliance obligation requires a broker-dealer to establish, maintain, and enforce written policies and procedures that are reasonably designed to achieve compliance with Regulation Best Interest, considered on the whole.
- <u>Document Requests</u>: To determine compliance with this obligation, according to the Best Interest Risk Alert, Staff may review "the broker-dealer's policies and procedures and evaluate any controls, remediation of noncompliance, training, and periodic review and testing included as part of those policies and procedures."

<u>Conclusion</u>

The Best Interest Risk Alert indicated that, although these are the primary focus areas of the initial examinations, the Staff may select additional areas for review based on risks identified during examinations.

Form CRS Risk Alert

The Form CRS Risk Alert focused on providing broker-dealers and investment advisers with information about the scope and content of initial examinations after the June 30, 2020 compliance date. According to the Form CRS Risk Alert, Form CRS and its related rules ("**Form CRS**") require broker-dealer and investment adviser firms to deliver to retail investors a customer or client relationship summary ("**relationship summary**") that provides information about such firm. Firms are also required to file their initial relationship summaries (and any amendments) with the SEC and publish the current relationship summary on the firm's website, if the firm has one. After June 30, 2020, OCIE will begin examinations to determine compliance with Form CRS, and initial examinations will focus on determining whether firms have made a good faith effort to implement the Form CRS requirements.

According to the Form CRS Risk Alert, initial examinations of firms may focus on the following areas in assessing Form CRS compliance: (i) delivery and filing, (ii) content, (iii) formatting, (iv) updates and (v) recordkeeping.

<u>Delivery and Filing</u>: According to the Form CRS Risk Alert, the Staff may (i) review whether the firm has filed its relationship summary, including any amendments, with the SEC and whether the relationship summary is available on the firm's website, (ii) evaluate the process for delivering such relationship summary to existing and new retail investors and (iii) review policies and procedures to determine whether such policies and procedures address the required relationship summary delivery processes and dates.

According to the Form CRS Risk Alert, the Staff may review records of the dates that each relationship summary was provided to retail investors to confirm whether the firm has complied with the following obligations:

- *Existing Retail Investors*. The initial delivery of the relationship summary to existing retail investors by July 30, 2020 and before or at the time of:
    - The opening of a new account that is different from the retail investor's existing account;
    - A recommendation of a rollover of assets from a retirement account into a new or existing account or investment; or
    - A recommendation of a new brokerage or advisory service or investment that does not necessarily involve the opening of a new account and would not be held in an existing account (for example, a first time purchase of a direct-sold mutual fund through a "check and application" process).
- *New Retail Investors*. The delivery of the relationship summary to new retail investors before or at the earliest of:
    - For investment advisers, entering into an advisory contract with the retail investor;
    - For broker-dealers, (i) a recommendation to a retail investor of an account type, a securities transaction or an investment strategy involving securities; (ii) placing an order for the retail investor; or (iii) the opening of a brokerage account for the retail investor.

<u>Content</u>: Staff may review a firm's relationship summary to assess whether it (i) includes all necessary information and (ii) contains true and accurate information and does not omit any material facts necessary in order to make the disclosures, in light of the circumstances under which they were made, not misleading. For example, according to the Form CRS Risk Alert, the Staff may review relationship summaries for information about:

- "How the firm describes the relationships and services it offers to retail investors, including statements regarding account monitoring and investment authority.
- How the firm describes its costs and fees, including disclosures about the principal costs and fees that retail investors will incur, other costs and fees related to services and investments that retail investors will pay directly or indirectly, and examples of the categories of the most common fees and costs applicable to the firm's retail investors (e.g., custodian fees, account maintenance fees, fees related to mutual funds and variable annuities, and other transactional fees and product-level fees).
    - Staff may review fee schedules, advisory agreements, and brokerage agreements and compare the fees listed in those documents against the fees listed in the relationship summary.
- How the firm describes the manner in which its financial professionals are compensated, including cash and noncash compensation, and the conflicts of interest those payments create.

- How the firm describes its conflicts of interest, including incentives related to proprietary products, third-party payments, revenue sharing and principal trading.
- Whether the firm accurately discloses if the firm or its financial professionals have legal or disciplinary history."

Formatting: Staff may also review a firm's relationship summary to assess whether it is formatted according to the form's instructions (for example, whether required wording is included, whether required text features are included and whether the writing is in plain English).

Updates: Staff may also review a firm's policies and procedures for updating the relationship summary to (i) determine how and whether a firm updates and files its relationship summary within 30 days after any information therein becomes materially inaccurate, (ii) determine how and whether a firm communicates such changes to retail investors within 60 days after the updates are required to be made and (iii) evaluate the firm's process for highlighting to retail investors the most recent changes and including an exhibit highlighting or summarizing any material changes with any filed updates.

Recordkeeping: Staff may also review a firm's records related to delivery of the relationship summary, and the policies and procedures regarding record-making and recordkeeping, to determine how and whether the firm complies with applicable delivery and recordkeeping obligations.

Conclusion

The Form CRS Risk Alert concluded by noting the OCIE's desire that firms will use the Form CRS Risk Alert to assess their implementation plans for Form CRS.

- **See a copy of the Press Release**
- **See a copy of the Best Interest Risk Alert**
- **See a copy of the Form CRS Risk Alert**

Litigation

SEC Settles with Investment Adviser for Alleged Undisclosed Conflicts of Interest Regarding In-House Operations Fees

On April 22, 2020, the SEC issued an order (the "**Monomoy Order**") instituting and settling cease-and-desist proceedings against Monomoy Capital Management, L.P. ("**Monomoy**"), a private equity fund adviser, arising out of Monomoy's alleged practice of charging portfolio companies for the services of its in-house Operations Group without adequately disclosing this practice to investors. Although the pace of enforcement actions regarding alleged conflicts of interest arising from allocation of expenses between managers and investors has decreased in recent years,[1] the Monomoy Order serves as a reminder that this remains a key area of enforcement focus.

Monomoy manages several private equity funds, including a complex of funds described in the Monomoy Order as "**Fund II**". Fund II was governed by a limited partnership agreement ("**LPA**") and private placement memorandum ("**PPM**") that described the management of Fund II, and explained that Monomoy charges Fund II a management fee of 2% of the limited partner's committed capital for the initial

[1] For an in-depth overview of the SEC's settlements with investment advisers regarding fee and expense allocation, see **Allocating Fees and Expenses: The SEC Is Paying Close Attention**, The International Comparative Legal Guide to: Alternative Investment Funds 2017, 5th Edition.

five years of the fund's life, and, thereafter, a management fee of 2% of the limited partner's invested capital.

The Monomoy Order explains that since 2007, Monomoy provided portfolio companies with the services of its Operations Group; Monomoy described the Operations Group in the Fund II PPM and in Fund II marketing materials. The SEC alleges that Monomoy had an "established practice" of billing portfolio companies for the costs of providing Operations Group services, rather than covering the costs of the Operations Group through Monomoy's management fee. According to the Monomoy Order, from April 2012 through December 2016, fees paid by Fund II portfolio companies for Operations Group services represented about 13.3% of all revenue Monomoy received with respect to Fund II during that period.

The SEC alleges that Monomoy did not "fully and fairly disclose" that it would separately charge Fund II's portfolio companies for the Operations Group costs or the conflicts of interest associated with this practice, and that Monomoy did not obtain informed consent from limited partners for these conflicts of interest. Prior to 2014, Monomoy's disclosures allegedly did not describe any reimbursement that Monomoy would receive for the cost of Operations Group services. Notably, although the Fund II LPA did disclose that portfolio companies were responsible for paying Monomoy fees, including "closing fees, investment banking fees, placement fees, monitoring fees, consulting fees, directors' fees and other similar fees," the LPA allegedly did not mention the Operations Group or specifically disclose that Monomoy would receive reimbursement for Operations Group services to portfolio companies. While Monomoy did file, in March 2014, a Form ADV that disclosed "under specific circumstances, certain Monomoy operating professionals may provide services to portfolio companies that typically would otherwise be performed by third parties," and that "Monomoy may be reimbursed" for costs related to such services," the SEC alleges that those statements did not adequately disclose that Monomoy "routinely" provided and was reimbursed for such services.

The SEC alleged that as a result of the conduct described above, Monomoy violated Section 206(2) of the Advisers Act. The Monomoy Order notes that Monomoy cooperated with the SEC staff throughout the investigation. Monomoy agreed to cease and desist from future violations, to be censured, and to pay a total of $1,926,579: $1,521,972 in disgorgement, $204,606 in prejudgment interest, and $200,000 in civil monetary penalties.

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

SEC Settles with Investment Adviser for Alleged Advertising Omissions

On April 17, 2020, the SEC issued an order (the "**OIE Order**") instituting and settling cease-and-desist proceedings against Old Ironsides Energy, LLC ("**Old Ironsides**"), a registered investment adviser, arising out of alleged material omissions from Old Ironsides' marketing materials.

Old Ironsides advised a private fund, Old Ironsides Energy Fund II LP ("**OIE Fund**"). The principals of Old Ironsides had previously managed a portfolio of oil and gas investments (which the OIE Order calls the "**Legacy Portfolio**") for their previous employer. The Legacy Portfolio contained direct drilling investments, private equity investments, and private fund investments. The OIE Order states that the "vast majority" of investments in the Legacy Portfolio were direct drilling investments.

Old Ironsides' marketing materials stated that the OIE Fund would only invest in direct drilling investments, private equity investments, and midstream assets, and emphasized the principals' management of the Legacy Portfolio. Marketing materials also provided a "Track Record," which was described as the investment performance of early stage direct drilling investments in the Legacy Portfolio. The SEC alleges that the track record contained in marketing materials categorized a private fund investment as an early stage direct drilling investment, and that the marketing materials did not describe how that fund investment differed from early stage direct drilling investments.

According to the SEC, including that private fund in the calculation of the track record improved the track record, as at the time that the marketing materials were created the private fund investment had a return of 10.9x, while investments in early stage direct drilling investments had lower returns.

At the time Old Ironsides prepared these materials, Old Ironsides' compliance manual included policies and procedures that prohibited any advertisement containing a material false statement or that omitted material facts, as well as policies and procedures governing the use of investment performance in marketing materials. The SEC alleges that Old Ironsides failed to implement these compliance policies and procedures in allowing the distribution of marketing materials that omitted material information about the calculation of the performance of the Legacy Portfolio.

The SEC alleged that on account of its conduct, Old Ironsides violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which require a registered investment adviser to adopt and implement policies and procedures reasonably designed to prevent violation of the Advisers Act and rules under the Advisers Act, and Rule 206(4)-1(a)(5) thereunder, which make it a "fraudulent, deceptive, or manipulative" act or practice to publish or distribute advertisements that contain untrue statements of material fact or that are otherwise false or misleading.

Old Ironsides agreed to cease and desist from future violations, to be censured, and to pay $1,000,000 in civil monetary penalties.

- **See a copy of the Old Ironsides Order**

SEC Obtains Partial Summary Judgment Against Investment Adviser and Principal

On February 13, 2020, the SEC won partial summary judgment in its pending action against Navellier & Associates, Inc. ("**Navellier**"), an investment adviser, and its founder and chief investment officer, Louis Navellier. The SEC action against Navellier and Louis Navellier has been pending since August 2017.

In its complaint, filed in the U.S. District Court for the District of Massachusetts, the SEC alleged that Louis Navellier and his firm misled clients about the track record of the "Vireo AlphaSector" strategy Navellier offered, and ignored and concealed "red flags" indicating that the strategy was not performing as advertised.

According to the complaint, around September 2009, Navellier began to explore doing business with F-Squared, a former investment adviser that marketed a strategy called "AlphaSector." In a 2014 SEC enforcement action, F-Squared admitted that it had made false claims about the AlphaSector strategy's performance and "fabricated" a performance record by back-testing. As Navellier explored doing business with F-Squared, Navellier's CCO conducted due diligence which "failed to corroborate" F-Squared's claims. Navellier never "checked F-Squared's claimed historical performance," which the SEC alleges would have revealed that F-Squared's performance information was false. Navellier's CCO allegedly cited four factors that led to his decision to recommend the F-Squared AlphaSector products: that another fund family had conducted diligence and partnered with F-Squared, that F-Squared was reporting trades after October 2008, that the F-Squared Board of Advisors included well-known individuals, and that the CCO found the "backgrounds of the principals" of F-Squared favorable.

Navellier incorporated charts and data based on the F-Squared AlphaSector strategy, even though F-Squared had not provided Navellier with any support for its claims. Navellier also allegedly represented that the AlphaSector strategy had outperformed various investment benchmarks from 2001 through 2008, and that its performance was based on a track record of actual investments. By March 2011, Navellier allegedly learned that the AlphaSector track record was back-tested and not based on actual investments, but nonetheless continued to repeat F-Squared's claims about AlphaSector to Navellier clients. In August 2018, Navellier sold its Vireo AlphaSector business to F-Squared for $14 million; Navellier allegedly never corrected its representations to clients, nor did it disclose the conflict of interest created by the sale to F-Squared.

On February 13, 2020, Judge Casper granted the SEC's motion for summary judgment that Navellier and Louis Navellier violated Sections 206(1) and 206(2) of the Advisers Act. Judge Casper concluded that the undisputed facts demonstrated that defendants had made false claims about AlphaSector, and that they knew that their statements regarding the AlphaSector track record were false but nonetheless continued to use these claims to market the AlphaSector strategy.

Judge Casper also rejected Navellier and Louis Navellier's affirmative defense of selective enforcement, in which they posited that the SEC had not brought civil suits against others that did business with F-Squared. Because the SEC offered a rational basis for a civil suit against these defendants—that they allegedly ignored SEC warnings and were aware that F-Squared's marketing materials were false and nonetheless continued to use them—Judge Casper granted the SEC summary judgment denying their selective enforcement defense.

- **See a copy of the Summary Judgment Order**

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