# Investment Management Regulatory Update

June 29, 2020

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## 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 Extends Relief for Virtual Meetings of Registered Fund Boards

On June 19, 2020, the Securities and Exchange Commission ("**SEC**") issued an order extending the time period for the conditional relief that was provided in a March 25, 2020 order from certain in-person board meeting requirements under the Investment Company Act of 1940, as amended ("**Investment Company Act**"). In light of the continuing challenges presented by the COVID-19 outbreak, the SEC extended the time period for the conditional relief from such in-person board meeting requirements to December 31, 2020. The time periods for other conditional relief provided in the prior order have not been extended and will expire as provided therein. Please see Davis Polk's **Client Alert** for more information on the relief provided in the prior order.

- **See a copy of the June 19, 2020 order**

# Rules and Regulations

## SEC's Division of Investment Management Delivers No-Action Letter to Investment Company Institute and SIFMA AMG

The Federal Reserve Board, with the approval of the Secretary of the U.S. Department of Treasury, established the 2020 Term Asset-Backed Securities Loan Facility ("**TALF 2020**") on March 23, 2020, in response to the impact of the COVID-19 outbreak. On May 27, 2020, the SEC's Division of Investment Management (the "**Division**") issued a no-action letter to the Investment Company Institute and the Securities Industry and Financial Markets Association, Asset Management Group (the "**2020 No-Action Letter**") with respect to registered investment companies that are considering participating in TALF 2020. In the 2020 No-Action Letter, the Division reaffirmed its positions in two prior no-action letters, recognizing the similarity of TALF 2020 to the Term-Asset Backed Securities Loan Facility established by the Department of Treasury and Federal Reserve Board in response to the 2008 financial crisis ("**TALF 2008**").

In the 2020 No-Action Letter, the Division reaffirmed its position in Franklin Templeton Investments, SEC No-Action Letter (Jun. 19, 2009) (the "**Franklin Letter**"), to permit certain registered closed-end or open-end investment companies, including closed-end funds that have elected to be regulated as business development companies ("**BDCs**"), to participate in TALF 2020 without treating the borrowing as a senior security representing indebtedness for purposes of compliance with Sections 18(a)(1), 18(c) and 18(f)(1) of the Investment Company Act. The Division also reaffirmed its no-action position under Section 17(f) of the Investment Company Act in the Franklin Letter with respect to registered investment companies' participation in the unique custody arrangements necessitated by TALF 2020.

In the 2020 No-Action Letter, the Division also reaffirmed its position in T. Rowe Price Associates, Inc., SEC No-Action Letter (Oct. 8, 2009) (the "**T. Rowe Price Letter**") to permit registered investment companies and institutional separately managed accounts and common trust funds to participate in TALF 2020 by purchasing interests in a private fund that was organized for the specific purpose of acquiring eligible collateral and obtaining loans under TALF 2020, without first obtaining an exemptive order pursuant to Section 17(b) of the Investment Company Act or Rule 17d-1 thereunder. The Division also expanded this no-action position so that it applies to BDCs and may be relied on by third parties.[1]

- **See a copy of the 2020 No-Action Letter**

## CFTC Adopts a Final Rule Limiting Commodity Pool Operator Registration Exemption

On June 4, 2020, the Commodity Futures Trading Commission ("**CFTC**") adopted an amendment to Regulation 4.13 (the "**new Final Rule**") that will limit the ability of commodity pool operators ("**CPOs**") to claim an exemption from registration if they, or their principals, have statutory disqualifications under section 8a(2) of the Commodity Exchange Act ("**CEA**") in their backgrounds ("**Covered Statutory Disqualifications**"). The CFTC staff had become aware of a number of statutorily disqualified CPOs legally operating commodity pools under a prior exemption that had been rescinded (Regulation 4.13(a)(4)), which was a factor leading to the CFTC's adoption of this new Final Rule. The CFTC believes that the adoption of this new Final Rule will enhance consumer protection for participants in exempt commodity pools.

[1] The SEC staff's response in the original T. Rowe Price Letter stated that: "In light of the very fact specific nature of T. Rowe Price's request . . . the position expressed in this letter applies only to the entities seeking relief, and no other entity may rely on this position."

## The Old Regime

Under the CEA, a person acting as a CPO[2] must register with the CFTC or rely on an exemption from registration as such.[3] In certain enumerated situations, CEA section 8a(2) authorizes the CFTC to refuse to register, to register conditionally, to suspend the registration of, or place restrictions upon, any person's registration upon notice but without a hearing, and it authorizes the CFTC in those same situations to revoke any person's registration with such a hearing.[4] If the CFTC discovers—either through the applicant's own disclosure or through other means—that an applicant for registration, or any of its principals, has one of the section 8a(2) statutory disqualifications in its background, the CFTC will typically refuse registration on that basis.

Regulation 4.13(a)(3) exempts from registration as CPOs the operators of privately offered commodity pools that limit their trading in commodity interest positions (including both hedging and speculative positions, and positions in security futures) so that either (i) no more than 5% of the liquidation value of the commodity pool's portfolio is used as margin to establish such positions, or (ii) the aggregate net notional value of such positions held by the commodity pool does not exceed 100% of the pool's liquidation value. Persons relying on the exemption under Regulation 4.13(a)(3) must file a notice of eligibility for such exemption with the National Futures Association ("**NFA**"). Prior to the new Final Rule, persons claiming an exemption from registration as a CPO under Regulation 4.13(a)(3) did not need to disclose previous disciplinary matters that might affect their registration eligibility. As a result, the CFTC noted that there was a regulatory gap between entities seeking registration as a CPO (who need to disclose certain statutory disqualifications and are generally refused registration in the event of such disqualifications) and those persons claiming the Regulation 4.13(a)(3) exemption.

## The new Final Rule

The new Final Rule requires a CPO, as a condition of relying on the exemption under Regulation 4.13(a)(3), to represent that, subject to limited exceptions, neither the CPO nor any of its principals has in their background a "statutory disqualification" under section 8a(2) of the CEA that would require disclosure if the claimant sought registration with the CFTC. This representation would be made by the CPO in its annual notice filing to claim the exemption under newly amended Regulation 4.13(b)(1)(iii). A "statutory disqualification" under section 8a(2) includes, among others:

- a prior registration having been suspended (and the period of such suspension has not yet expired) or revoked;
- having been enjoined from certain commodities-related activities, such as acting as a futures commission merchant, commodity trading advisor, commodity pool operator or various other financial market participant roles;
- having been enjoined from engaging in certain fraudulent behaviors, such as embezzlement, theft, extortion, fraudulent conversion, and others;
- having been found to have violated federal commodities or securities laws and felony convictions within the past 10 years.

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[2] The CEA defines the term "commodity pool operator" as "any person . . . engaged in a business that is of the nature of a commodity pool, investment trust, syndicate, or similar form of enterprise, and who, in connection therewith, solicits, accepts, or receives from others, funds, securities, or property . . . for the purpose of trading in commodity interests . . . ." 7 U.S.C. 1a(11).

[3] 7 U.S.C. 6m(1); 17 C.F.R. 4.13.

[4] 7 U.S.C. 12a(2).

The CFTC's rationale in limiting Covered Statutory Disqualifications to those enumerated in section 8a(2) (as opposed to those in section 8a(3)[5]) is that the new Final Rule should be tailored to the most serious offenses only (i.e., those that would warrant statutory disqualification without a prior hearing) because the regulatory regime permits exempt CPOs, as opposed to registered CPOs, freedom from certain compliance obligations.

The new Final Rule further provides one narrow exception from this prohibition where such disqualification arises from a matter which was disclosed in connection with a previous application in which such registration was granted. Otherwise, a CPO that has a covered section 8a(2) disqualification would be unable to make the newly required representation and, therefore, would be ineligible for the Rule 4.13(a)(3) exemption. Such a CPO may seek exemptive relief from the CFTC, such that it may continue to rely on the exemption despite the statutory disqualification, or — as described by the CFTC in adopting the rule — could seek to register with the CFTC, in a process that would more fully consider the implications of the statutory disqualification. Should the applicant be permitted to register, the CPO would be subject to the CFTC's ongoing oversight and subject to all relevant statutory and regulatory requirements.

The new Final Rule will become effective within 60 days of publication in the Federal Register, though CPOs currently relying on the Regulation 4.13(a)(3) exemption will not need to comply with the new regime immediately. CPOs currently relying on Regulation 4.13(a)(3) will have until their next filing requirement in the 2021 cycle (i.e., March 1, 2021) to comply. In contrast, any CPOs claiming a Regulation 4.13(a)(3) exemption for the first time on or after the new Final Rule's effective date will need to comply immediately following its effectiveness.

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

### Final Volcker Rule 2.1 – Covered Funds

On June 26, 2020, the Federal Reserve, OCC, FDIC, SEC and CFTC approved final amendments to the covered funds portion of the regulations implementing the Volcker Rule with an effective date of October 1, 2020. Davis Polk has published a **Client Memorandum** that discusses the final rule, which largely adopts the amendments as proposed, and points out the few key differences.

## Industry Update

### The SEC Delivers Staff Statement Revoking Prior Staff Letter on Control Share Statutes and Investment Company Act Section 18(i)

On May 27, 2020, the SEC issued a staff statement addressing the interplay between Section 18(i) of the Investment Company Act and state control share statutes (the "**2020 Statement**"). Specifically, the SEC staff revoked its position in a prior no-action letter, issued in 2010 (the "**Boulder Letter**"), [6] which addressed the interaction between the Maryland Control Share Acquisition Act ("**MCSAA**") and Section 18(i) of the Investment Company Act.

#### Section 18(i) and Control Shares

[5] Section 8a(3) disqualifications are structured differently from section 8a(2) disqualifications, in that section 8a(3) disqualifications prohibit an applicant's registration with the CFTC only after a formal hearing has found both that the disqualification has occurred and that such disqualification should prevent registration.

[6] Boulder Total Return Fund, SEC No-Action Letter (Nov. 15, 2010).

Section 18(i) of the Investment Company Act generally provides that every share of stock issued by a registered management company must be a voting stock that has equal voting rights with every other outstanding voting stock.

State control share statutes allow a company to alter or remove the voting rights of a shareholder when that shareholder obtains control of a certain percentage of the total number of voting shares. Such voting rights generally may only be restored if a certain percentage of the remaining, disinterested shareholders vote to approve the restoration. According to the 2020 Statement, about half of the states have some form of control share statute—some allow the company to opt-out or opt-in—which generally applies to closed-end funds but not to open-end funds.

**Revoking the Boulder Letter**

In the Boulder Letter, the SEC staff concluded that it would be a violation of Section 18(i) of the Investment Company Act if a closed-end fund opted into Maryland's control share statute.

On May 27, 2020, after considering developments in the market and collecting feedback from affected market participants, the SEC revoked its position in the Boulder Letter and stated that it would not recommend enforcement action against a closed-end fund that opted into a control share statute, so long as the fund board's decision was taken with "reasonable care on a basis consistent with other applicable duties and laws and the duty to the fund and its shareholders generally." The SEC staff reminded market participants that "any actions taken by a board of a fund, including with regard to control share statutes, should be examined in light of: (1) the board's fiduciary obligations to the fund, (2) applicable federal and state law provisions and (3) the particular facts and circumstances surrounding the board's action."

The SEC staff also requested feedback from market participants with respect to the application of the Investment Company Act and the rules and regulations thereunder to control share statutes.

- **See a copy of the SEC staff statement**

## OCIE Issues Risk Alert on Observations from Examinations of Investment Advisers Managing Private Funds

On June 23, 2020 the OCIE issued a Risk Alert outlining its observations in examinations of registered investment advisers that manage private equity funds or hedge funds. In the Risk Alert, the OCIE noted that many of the deficiencies it observed may have caused private fund investors "to pay more in fees and expenses than they should have or resulted in investors not being informed of relevant conflicts of interest concerning the private fund adviser and the fund." The Risk Alert outlined three general areas of deficiencies observed by OCIE staff in its examinations of private fund advisers: (i) conflicts of interest, (ii) fees and expenses, and (iii) policies and procedures relating to material non-public information ("**MNPI**").

**Conflicts of Interest**: According to the Risk Alert, the OCIE staff observed the following conflicts of interest that appeared to be inadequately disclosed and deficient under Section 206 of the Investment Advisers Act of 1940, as amended ("**Advisers Act**") or Rule 206(4)-8 thereunder:

- *Conflicts related to allocations of investments*. The staff observed that certain private fund advisers did not provide adequate disclosure about conflicts relating to allocations of investments among clients, including: the adviser's largest flagship funds, co-investment vehicles that invest alongside flagship funds, sub-advised mutual funds, collateralized loan obligation funds, and separately managed accounts (together, "**clients**"). For example:
    - "The staff observed private fund advisers that preferentially allocated limited investment opportunities to new clients, higher fee-paying clients, or proprietary accounts or proprietary-controlled clients, thereby depriving certain investors of limited investment opportunities without adequate disclosure."

  - "The staff observed private fund advisers that allocated securities at different prices or in apparently inequitable amounts among clients (1) without providing adequate disclosure about the allocation process or (2) in a manner inconsistent with the allocation process disclosed to investors, thereby causing certain investors to pay more for investments or not to receive their equitable allocation of such investments."

- *Conflicts related to multiple clients investing in the same portfolio company*. The staff observed that certain private fund advisers did not provide adequate disclosure of the conflicts of interests that were created when the advisers' clients invested at different levels of the capital structure of the same portfolio company, e.g., when one client owned debt and another client owned equity in a single portfolio company.

- *Conflicts related to financial relationships between investors or clients and the adviser*. The staff observed that certain private fund advisers did not provide adequate disclosure regarding economic relationships between such advisers and select investors or clients, e.g., select investors that acted as seed investors in the adviser's private funds, or select investors that had economic interests in the adviser by, for example, providing credit facilities or other financing to the adviser or the adviser's private fund clients. According to the Risk Alert, "[f]ailure to provide adequate disclosure about these arrangements meant that other investors did not have important information related to conflicts associated with their investments."

- *Conflicts related to preferential liquidity rights*. The staff observed that certain private fund advisers did not provide adequate disclosure about side letters that they entered into with select investors that provided special terms, including preferential liquidity terms. The Risk Alert noted that "[A]s a result, some investors were unaware of the potential harm that could be caused if the selected investors exercised the special terms granted by the side letters."

  The staff also observed that certain private fund advisers failed to disclose information regarding side-by-side vehicles or SMAs that the advisers established to invest alongside their flagship funds, but with preferential liquidity terms. According to the Risk Alert, "[f]ailure to disclose these special terms adequately meant that some investors were unaware of the potential harm that could be caused by selected investors redeeming their investments ahead of other investors, particularly in times of market dislocation where there is a greater likelihood of a financial impact."

- *Conflicts related to private fund adviser interests in recommended investments*. The staff observed that certain private fund advisers failed to provide adequate disclosure of their interests in investments recommended to clients. In some cases, advisers failed to disclose that their principals and employees had preexisting ownership interests or other financial interests, such as referral fees or stock options, in such investments.

- *Conflicts related to coinvestments*. The staff observed potentially misleading disclosure related to investments by coinvestment vehicles and other coinvestors, and how these coinvestments operate. In some cases, the staff observed that certain private fund advisers failed to follow their disclosed process for allocating coinvestment opportunities among select investors, or among coinvestment vehicles and flagship funds. In other cases, the staff found that private fund advisers had agreements with certain investors regarding coinvestment opportunities, but did not provide adequate disclosure about such arrangements to other investors. According to the Risk Alert, "[t]his lack of adequate disclosure may have caused investors to not understand the scale of coinvestments and in what manner coinvestment opportunities would be allocated among investors."

- *Conflicts related to service providers*. The staff observed that certain private fund advisers failed to provide adequate disclosure of conflicts involving the adviser and service providers, e.g., service agreements that portfolio companies controlled by an adviser's private fund clients entered into with entities controlled by the adviser, its affiliates, or family members of its principals. The staff observed that some private fund advisers also failed to disclose other financial incentives with respect to portfolio companies' use of certain service providers, such as incentive payments from discount programs, and related conflicts. In some cases, the staff observed that certain private fund advisers did not have procedures in place to ensure that the advisers followed their disclosures related to affiliated service providers. For example, the Risk Alert noted that certain private fund advisers represented to investors that services provided to the private funds or portfolio companies by the advisers' affiliates would be provided on terms no less favorable than those that could be obtained from unaffiliated third parties. However, the staff observed that such advisers "did not have procedures or support to establish whether comparable services could be obtained from an unaffiliated third party on better terms, including at a lower cost."

- *Conflicts related to fund restructurings*. The staff observed that certain private fund advisers failed to provide adequate disclosure of conflicts related to fund restructurings (i.e., where an adviser arranges the sale of an existing private fund or the fund's portfolio)[7] and "stapled secondary transactions" (i.e., the purchase of a private fund's portfolio combined with an agreement by the purchaser to commit capital to a future fund of the adviser). For example:
    - "Advisers purchased fund interests from investors at discounts during restructurings without adequate disclosure regarding the value of the fund interests. The staff also observed advisers that did not provide adequate disclosure about investor options during restructurings, potentially impacting the decisions made by investors."
    - "Advisers did not provide adequate information in communications with investors about fund restructurings. The staff observed advisers that required any potential purchaser of investor interests to agree to a stapled secondary transaction or provide other economic benefits to the adviser without adequate disclosure about the conflict to investors.
- *Conflicts related to cross-transactions*. The staff observed that certain private fund advisers failed to provide adequate disclosure of conflicts related to purchase and sale transactions between clients, e.g., establishing the price at which securities would be transferred between client accounts in a manner that disadvantaged either the selling or purchasing client, but without providing adequate disclosure to its clients.

**Fees and Expenses**: According to the Risk Alert, the OCIE staff observed the following deficiencies under Section 206 of the Advisers Act or Rule 206(4)-8 thereunder with respect to fees and expenses:

- *Allocation of fees and expenses.* The staff observed inaccurate allocations of fees and expenses by private fund advisers, such as:
    - Allocation of shared expenses (e.g., expenses for broken deals, due diligence, annual meetings, consultants and insurance costs) among the adviser and its clients in a manner that was inconsistent with disclosures to clients or the adviser's policies and procedures.
    - Charging private fund investors for expenses that were not permitted under relevant fund documents, including adviser-related expenses (e.g., salaries for adviser personnel, and the adviser's compliance, regulatory filings and office expenses).

[7] The Risk Alert noted that the purchaser in a private fund restructuring often offers existing investors an option to sell their interests in the fund or roll their interests into a new restructured fund.

  - Failure to comply with contractual limits on certain expenses charged to investors (e.g., legal fees, placement agent fees).
  - Failure to follow the adviser's travel and entertainment expense policies.

- *"Operating partners."* The staff observed that certain private fund advisers failed to provide adequate disclosure regarding the role and compensation of "operating partners" (i.e., individuals who provide services to a private fund or portfolio company, but are not employees of the adviser). According to the Risk Alert, such inadequate disclosure potentially misled investors about who bore the cost of the operating partners' services, and potentially caused investors to overpay expenses.
- *Valuation*. The staff observed that certain private fund advisers failed to value client assets in accordance with their valuation procedures or with disclosures to clients, such as disclosures that client assets would be valued in accordance with GAAP. According to the Risk Alert, such failure "led to overcharging management fees and carried interest because such fees were based on inappropriately overvalued holdings."
- *Monitoring/board/deal fees and fee offsets.* The staff observed issues with certain private fund advisers' receipt of "portfolio company fees" (e.g., monitoring fees, board fees, deal fees). For example:
  - "Advisers failed to apply or calculate management fee offsets in accordance with disclosures and therefore caused investors to overpay management fees. In some instances, advisers incorrectly allocated portfolio company fees across fund clients, including private fund clients that paid no management fees. The staff also observed advisers that failed to offset portfolio company fees paid to an affiliate of the adviser that were required to be offset against management fees."
  - "Advisers disclosed management fee offsets, but did not have adequate policies and procedures to track the receipt of portfolio company fees, including compensation that their operating professionals may have received from portfolio companies, potentially causing investors to overpay management fees."
  - "Advisers negotiated long-term monitoring agreements with portfolio companies they controlled and then accelerated the related monitoring fees upon the sale of the portfolio company, without adequate disclosure of the arrangement to investors."

**MNPI/Code of Ethics**: According to the Risk Alert, the OCIE staff observed the following deficiencies under Section 204A of the Advisers Act or Rule 204A-1 thereunder:

- *Section 204A.* The staff observed that certain private fund advisers failed to comply with Section 204A, which requires investment advisers to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of MNPI. For example, the Risk Alert noted that certain private fund advisers did not address the following risks:
  - Risks posed by an adviser's employees interacting with: "(1) insiders of publicly-traded companies, (2) outside consultants arranged by 'expert network' firms, or (3) 'value added investors' (e.g., corporate executives or financial professional investors that have information about investments) in order to assess whether MNPI could have been exchanged. The staff also observed private fund advisers that did not enforce policies and procedures addressing these risks."
  - Risks posed by an adviser's employees who could obtain MNPI through their access to the office space or systems of the adviser or its affiliates possessing MNPI.

  - Risks posed by an adviser's employees who periodically had access to MNPI about issuers of public securities, such as in connection with a private investment in public equity.

- *Rule 204A-1*. The staff observed that certain private fund advisers failed to establish, maintain and enforce provisions of their codes of ethics reasonably designed to prevent the misuse of MNPI. For example, the staff observed that:
  - "Advisers did not enforce trading restrictions on securities that had been placed on the adviser's "restricted list." The staff also observed advisers that had codes of ethics that provided for the use of restricted lists, but did not have defined policies and procedures for adding securities to, or removing securities from, such lists."
  - Advisers failed to enforce their codes of ethics provisions regarding employees' receipt of gifts and entertainment from third parties.
  - Advisers failed to require their access persons to timely submit transactions and holdings reports, or submit certain personal securities transactions for preclearance, as required under their policies or Rule 204A-1. The staff also observed that advisers failed to correctly identify certain individuals as access persons under their codes of ethics.

The OCIE encouraged private fund advisers to review their practices and policies and procedures to address the issue outlined in the Risk Alert.

- **See a copy of the Risk Alert**

## OCIE Examination Initiative: LIBOR Transition Preparedness

On June 18, 2020, the SEC's Office of Compliance Inspections and Examinations ("**OCIE**") issued a Risk Alert noting that the expected discontinuation of LIBOR after 2021 may present a material risk for certain market participants, including registered investment advisers, broker-dealers, investment companies, municipal advisors, transfer agents and clearing agencies ("**Registrants**"). In the Risk Alert, the OCIE identified Registrants' preparedness for discontinuation of LIBOR and transition to an alternative reference rate as an examination priority for FY 2020. The OCIE stated that examinations will review, among other things, how a Registrant has evaluated the potential impact of a transition from LIBOR on the Registrant's business activities, operations, services, and customers, clients and/or investors, and the steps the Registrant has taken to prepare for such transition, including:

- The Registrant's and its investors' "exposure to LIBOR-linked contracts that extend past the current expected discontinuation date, including any fallback language incorporated into these contracts;"
- The Registrant's operational readiness "including any enhancements or modifications to systems, controls, processes, and risk or valuation models associated with the transition to a new reference rate or benchmark;"
- The Registrant's "disclosures, representations, and/or reporting to investors regarding its efforts to address LIBOR discontinuation and the adoption of alternative reference rates;"
- "Identifying and addressing any potential conflicts of interest associated with the LIBOR discontinuation and the adoption of alternative reference rates; and"
- The Registrant's "clients' efforts to replace LIBOR with an appropriate alternative reference rate."

The OCIE included in Appendix A to the Risk Alert a sample list of information the OCIE may request in conducting examinations of Registrants' preparedness for discontinuation of LIBOR, and encouraged

Registrants to consult the Alternative Reference Rates Committee website for updates and best practices regarding the transition from LIBOR.

- **See a copy of the Risk Alert**

## Litigation

### SEC Settles with Former Investment Adviser—on Remand after Appeal to Supreme Court—for Alleged Materially Misleading "Backtesting"

On June 16, 2020, the SEC issued an order (the "**Lucia Order**" or "**Order**") instituting and settling cease-and-desist proceedings against Raymond J. Lucia Companies, Inc. ("**RJL**"), a former registered investment adviser, and Raymond J. Lucia Sr. ("**Lucia**"), owner of RJL (collectively, "**Respondents**"). The Lucia Order was issued on remand from the Supreme Court's decision in ***Lucia v. Securities and Exchange Commission***, 138 S. Ct. 2044 (2018), which held that SEC Administrative Law Judges ("**ALJs**") are "Officers of the United States" subject to the Appointments Clause of the U.S. Constitution. (For a discussion of the Supreme Court's decision, please see Davis Polk's **Client Memorandum** dated June 25, 2018.)

The SEC's case against Respondents began in 2012, when the SEC instituted public administrative and cease-and-desist proceedings. The matter was assigned to an ALJ, who issued an initial decision on July 8, 2013, making factual findings and concluding that Lucia had violated the Investment Advisers Act of 1940, as amended ("**Advisers Act**") and imposing sanctions. On August 8, 2013, the SEC remanded the matter for additional fact-finding; on December 6, 2013, the ALJ issued an initial decision on remand. Respondents then filed a petition for review with the SEC, which the SEC granted.

On September 3, 2015, the SEC issued an opinion finding that, among other things, RJL violated, and Lucia willfully aided and abetted and caused RJL's violations of, the Advisers Act. On October 2, 2015, Respondents filed a petition for review with the United States Court of Appeals for the District of Columbia Circuit, arguing that ALJs are "Officers of the United States," who must be appointed in accordance with the Appointments Clause of the U.S. Constitution. On August 6, 2016, the D.C. Circuit denied the petition for review, concluding that ALJs are not "Officers of the United States." Respondents petitioned for certiorari to the Supreme Court.

On June 21, 2018, the Supreme Court of the United States reversed the decision of the D.C. Circuit and concluded that ALJs are "Officers of the United States" and, as such, must be appointed by "the President, a court of law, or a head of department" as required by the Appointments Clause. Because ALJs were not appointed by the President, a court, or a "head of department"—in this case, the SEC (i.e., the Commission itself, not a member of the SEC staff)—the Supreme Court remanded for a rehearing of Lucia's case by the SEC or by a duly appointed ALJ. On August 15, 2018, on remand from the Supreme Court, the D.C. Circuit issued an order granting the petition for review, setting aside the SEC's opinion and remanding the matter to the SEC for a new hearing.

On June 16, 2020, the SEC issued the Lucia Order instituting and settling cease-and-desist proceedings.

The Order alleges that between 2006 and 2010, Lucia appeared at seminars and used a PowerPoint presentation to promote the "Buckets of Money" strategy—which involved allocating assets to different buckets of short-term, medium-term, and long-term investments, drawing from short- and medium-term buckets to pay for expenses while allowing long-term investments to grow, and periodically reallocating assets from long-term investments to refill the short- and medium-term buckets—in an effort to generate new advisory clients for RJL. According to the Order, at the end of these presentations, Lucia would present slides purporting to show the results of how historical tests, which were referred to as "backtests," would have performed through different markets beginning in 1966. The "backtests" were presented at these seminars as "empirical, historical proof that the 'Buckets of Money' strategy provided inflation-adjusted income for life and growth of investment principal under difficult market conditions."

According to the SEC, the presentations classifying the so-called "backtests" as an accurate presentation of the historical performance of their strategy were "materially misleading" because they: (1) omitted material information about the effect of certain assumptions around inflation, rates of return on real estate investment trusts, and fees; (2) failed to disclose material information that Respondents' "backtest" methodology did not follow the "Buckets of Money" Strategy by reallocating assets periodically; and (3) failed to disclose material information that Respondents had no real support for how they derived the numbers presented as the results of their supposed 1973 "backtest." The SEC alleged that Lucia was the one responsible for the information presented in the PowerPoint and was involved in preparing and reviewing the "backtests" that were presented.

Based on the conduct described above, the SEC found that RJL violated Sections 206(1), 206(2), and 206(4) of the Advisers Act, and Rule 206(4)-1(a)(5) thereunder, and Lucia willfully aided and abetted and caused RJL's violations of Sections 206(1), 206(2), and 206(4) of the Advisers Act, and Rule 206(4)-1(a)(5) thereunder. Respondents consented to the entry of the Order and, without admitting or denying the findings, agreed to cease and desist from future violations. Lucia agreed to pay a civil money penalty of $25,000, and to be barred from the securities industry subject to a right to apply for reentry three years after September 2015 (meaning that Lucia has a right to reapply immediately). These sanctions are materially lower than the sanctions that were initially imposed (i.e., monetary penalties of $300,000 and a lifetime bar on Lucia).

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

## SEC Obtains $30 Million Judgment in Litigation against Investment Adviser and Principal

As reported in our **April 2020 Update**, in February 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. In the opinion granting summary judgment, Judge Casper of the U.S. District Court for the District of Massachusetts concluded that Navellier and Louis Navellier violated Sections 206(1) and 206(2) of the Advisers Act by making false claims about the "Vireo AlphaSector" investment strategy promoted by F-Squared, a former investment adviser, and that Navellier and Louis Navellier knowingly used a false track record to market the AlphaSector strategy.

On June 2, 2020, Judge Casper entered final judgment against Navellier and Louis Navellier. Judge Casper enjoined Navellier and Louis Navellier from violating Sections 206(1) and 206(2) of the Advisers Act, ordered them, jointly and severally, to pay disgorgement of $28,964,571, including $6,513,619 in prejudgment interest, ordered Navellier to pay civil penalties of $2 million, and ordered Louis Navellier to pay civil penalties of $500,000. Navellier and Louis Navellier have filed Notices of Appeal, preserving their right to appeal the decision and judgment to the U.S. Court of Appeals for the First Circuit.[8]

On June 12, 2020, the SEC also instituted administrative proceedings against Navellier and Louis Navellier to determine what remedial action would be appropriate and in the public interest on account of the judgment entered against them.

- **See a copy of the SEC Press Release regarding the final judgment**
- **See a copy of the SEC Order Instituting Administrative Proceedings**

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[8] Defendants had previously sought to appeal from Judge Casper's February 2020 order granting partial summary judgment, before final judgment was entered. That appeal was dismissed on June 15, 2020 for lack of appellate jurisdiction (because the order granting partial summary judgment was not itself an appealable final order until Judge Casper's entry of judgment).

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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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