Investment Management Regulatory Update

March 31, 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 Issues Targeted Regulatory Relief for Advisers and Registered Funds Affected by the Coronavirus Outbreak

On March 13, 2020 and March 25, 2020, the SEC issued exemptive orders providing temporary relief from certain filing and delivery obligations under the Advisers Act and the Investment Company Act to advisers, registered funds and BDCs whose operations have been affected by the coronavirus. According to the exemptive orders, the SEC is providing such relief in light of the quarantines and disruption to transportation affecting advisers' and funds' access to their personnel and third-party service providers, which have made timely compliance with such obligations more challenging.

Davis Polk has published a **Client Alert** discussing the exemptive orders.

SEC Provides Temporary Additional Flexibility for Registered Funds Affected by the Coronavirus Outbreak to Address Liquidity Issues Through Affiliate Arrangements

The SEC provided additional temporary relief to help registered funds manage potential liquidity issues in the current market environment that may be caused by the COVID-19 outbreak. The temporary relief includes an exemptive order with respect to certain affiliate borrowing and lending arrangements, and a no-action letter permitting money market funds to sell securities to affiliates under certain circumstances.

Davis Polk has published a **Client Alert** discussing the exemptive order and no-action letter.

Further, on March 26, 2020, the SEC staff issued a temporary no-action letter to the Investment Company Institute to permit registered open-end investment companies that are not ETFs and do not hold themselves out as money market funds ("**Funds**") to sell debt securities under certain circumstances to their affiliated persons (or affiliated persons of such persons) that are not registered investment companies ("**Affiliated Purchasers**"). As described in the no-action letter, due to the market disruptions caused by the COVID-19 outbreak, Affiliated Purchasers may seek to purchase debt securities from the Funds in order to enhance the Funds' liquidity and to fund shareholder redemptions. However, such Affiliated Purchasers are unable to do so because of restrictions on affiliated transactions under Section 17(a) of the Investment Company Act. In addition, the Funds are unable to rely on Rule 17a-9 under the Investment Company Act because the Funds do not hold themselves out as money market funds. The SEC staff therefore issued the no-action letter to permit Funds to sell securities to Affiliated Purchasers subject to the following conditions:

1. The purchase price is paid in cash;
2. The price of the purchased debt security is its fair market value under Section 2(a)(41) of the Investment Company Act, provided that this price is not materially different from the fair market value of the security indicated by a reliable third-party pricing service;
3. In the event that the Affiliated Purchaser thereafter sells the purchased security for a higher price than the purchase price paid to the Fund, the Affiliated Purchaser shall promptly pay to the Fund the amount by which the subsequent sale price exceeds the purchase price paid to the Fund. If the Affiliated Purchaser is subject to Sections 23A and 23B of the Federal Reserve Act, this condition does not apply to the extent that it would otherwise conflict with (a) applicable banking regulations or (b) any applicable exemption from such regulations issued by the Board of Governors of the Federal Reserve System;
4. Within one business day of the purchase of the security, the Fund publicly posts on its website and informs the SEC staff via email to **IM-EmergencyRelief@sec.gov** stating the name of the Fund, the name of the Affiliated Purchaser, the securities purchased (including a legal identifier if available), the amount purchased, and the total price paid; and
5. The relief shall be in effect on a temporary basis in response to the national emergency concerning the COVID-19 outbreak, which was proclaimed by the President of the United States on March 13, 2020, and will cease to be in effect upon notice from the SEC Staff.

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

CFTC and NFA Provide Temporary Regulatory Relief to Commodity Pool Operators and Commodity Trading Advisers in Response to the COVID-19 Outbreak

On March 20, 2020, the Commodity Futures Trading Commission ("**CFTC**") staff issued a no-action letter to provide regulatory relief to market participants registered with the CFTC as commodity pool operators ("**CPOs**") whose operations may be affected by the COVID-19 outbreak. In the no-action letter, the CFTC staff recognized that the disruptions in transportation and limited access to facilities and support staff due to the outbreak may present challenges for CPOs in timely meeting certain obligations under the Commodity Exchange Act and CFTC regulations. According to the no-action letter, CPOs relying on the no-action letter "are expected to establish and maintain a supervisory system that is reasonably designed to supervise the activities of personnel while acting from an alternative or remote location during the COVID-19 pandemic."[1]

The no-action letter provides the following relief:

- Form CPO-PQR under CFTC Regulation 4.27 – extension of the filing deadline to May 15, 2020 for annual report filings by small and mid-sized CPOs; and to July 15, 2020 for the quarterly report filing for the first quarter of 2020 by large CPOs.
- Pool Annual Report under CFTC Regulations 4.7(b)(3) and 4.22(c) – 45-day extension to provide and file pool annual reports due on or before April 30, 2020. The no-action letter notes that this does not foreclose a CPO from requesting an additional extension of time under CFTC Regulation 4.22(f).
- Periodic Account Statements under CFTC Regulations 4.7(b)(2) or 4.22(b) – extension of the deadline to distribute monthly or quarterly account statements to within 45 days of the end of the applicable reporting period, for reporting periods ending on or before April 30, 2020.

On March 23, 2020, the National Future Association ("**NFA**") provided related relief in Notice I-20-15 which states that CPO members who comply with the extended due dates provided in the CFTC no-action letter described above with respect to pool annual reports and periodic pool account statements will be deemed to be in compliance with the NFA's related requirements under NFA Compliance Rule 2-13. In Notice I-20-15, the NFA also extended the due date for:

- The quarterly Form PQR filing by CPO members for: (a) the quarter ended December 31, 2019 (originally due on March 30) to May 15, 2020 and (b) the quarter ended March 31, 2020 (originally due on May 30) to July 15, 2020; and
- The quarterly Form PR filing by CTA members for the quarter ended March 31, 2020 (originally due on May 15) to June 30, 2020.

- **See a copy of the CFTC No-Action Letter**
- **See a copy of NFA Notice I-20-15**

Rules and Regulations

SEC Amends Exemptions from Investment Adviser Registration for Advisers to Rural Business Investment Companies

On March 2, 2020, the Securities and Exchange Commission (the "**SEC**") adopted amendments (the "**Amendments**") to Rules 203(l)-1 and 203(m)-1 (the "**Rules**") promulgated under the Investment Advisers Act of 1940, as amended (the "**Advisers Act**")—the SEC's rules regarding exemption from registration for certain advisers to venture capital funds and private funds, respectively—in order to implement congressionally mandated exemptions from registration for investment advisers who advise rural business

[1] The CFTC staff referred to an NFA notice issued to its members on March 13, 2020 stating that it would not pursue disciplinary action against a member that permits associated persons "to temporarily work from locations not listed as a branch office and without a branch manager provided that the [m]ember implements and documents alternative supervisory methods to adequately supervise the [associated person]'s activities and meet its recordkeeping requirements." See NFA Notice I-20-12 Coronavirus Update – NFA Branch Office Requirements, available at: **https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=5214**.

investment companies ("**RBICs**"). The exemptions were originally enacted as part of the RBIC Advisers Relief Act of 2018 (the "**Relief Act**"), which amended the Advisers Act.

According to the adopting release announcing the Amendments (the "**Adopting Release**"), the Relief Act amended section 203(l) of the Advisers Act, which exempts from registration any adviser who solely advises venture capital funds, by designating RBICs as venture capital funds for purposes of the exemption. Similarly, the Final Rule indicates that the Relief Act amended Advisers Act section 203(m), which exempts advisers who solely advise private funds and have assets under management of less than $150 million from registration requirements, by excluding RBIC assets from counting towards the $150 million limit. Therefore, the SEC adopted the Amendments to (i) include RBICs in the definition of the term "venture capital fund" for purposes of Rule 203(l)-1 and (ii) exclude RBIC assets from the definition of the term "assets under management" for purposes of Rule 203(m)-1. According to the Adopting Release, an investment adviser (including an adviser to RBICs) relying on the venture capital fund exemption or the private fund adviser exemption is considered an "exempt reporting adviser" for purposes of the Advisers Act and is therefore required to maintain certain records and file certain reports and information required by Form ADV with the SEC.

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

SEC Seeks Public Comment on Fund Names

On March 2, 2020, the SEC issued a request for comments (the "**Comment Request**") seeking public comment on Rule 35d-1 (the "**Names Rule**") under the Investment Company Act of 1940, as amended (the "**Investment Company Act**") and more generally the framework for addressing names of registered investment companies and business development companies that are likely to mislead investors about a fund's investments and risks. According to the SEC, the name of a registered investment company or a business development company (a "**fund**") is a tool for communicating with investors — it is often the first piece of information investors see, and a fund's name can have a significant impact on their investment decision. In the Comment Request, the SEC seeks to assess whether the existing rule is effective in prohibiting funds from using names that are materially deceptive or misleading, and whether there are alternatives the SEC should consider.

Fund names are subject to both the antifraud provisions of the federal securities laws, along with Section 35(d) of the Investment Company Act and the Names Rule. Section 35(d) prohibits any fund from adopting as part of its name "any word or words that the Commission finds are materially deceptive or misleading." According to the Comment Request, the Names Rule that was adopted in January 2001 requires a fund to invest at least 80 percent of its assets in the manner suggested by its name (whereas prior to the adoption of the Names Rule, funds considering then-current SEC staff guidance would typically select fund names based on a 65 percent threshold). If a fund's name suggests a particular type of investment, industry, or geographic focus, the fund must invest at least 80 percent of its assets in the type of investment, industry, country or geographic region suggested by its name. The Names Rule is not a safe harbor and *does not* apply to fund names that describe a fund's investment objective, strategy or policies.

According to the Comment Request, since the Names Rule was adopted in 2001, the SEC has identified a number of issues, including:

- Funds are increasingly using derivatives and other financial instruments that provide leverage, which may not fit comfortably into the asset-based test in the Names Rule when derivatives are used to provide exposure to a "type of investment."

- Funds are increasingly using certain hybrid financial instruments that have some, but not all, of the characteristics of more common asset types that are used in a fund's name.

- The number of index-based funds is growing. Indices tracked by such funds are not subject to the Names Rule, and index constituents may not closely track the types of investments suggested by the indices' names.

- There is a growing number of funds with investment mandates that include criteria requiring qualitative assessments or judgments of certain characteristics (i.e., an "ESG" mandate). Some funds may be treating such criteria as types of investments that are subject to the Names Rule, whereas other funds may be treating such criteria as investment strategies that are not subject to the Names Rule.
- Asset managers may have an incentive to use fund names as a way of differentiating new funds, which may drive managers to select fund names more likely to attract assets (such as names suggesting various emerging technologies), but may not be consistent with the purpose of the Names Rule.

To inform potential future steps, the SEC is seeking input on the challenges that the Names Rule may present, as well as potential alternatives to the current framework for prohibiting the use of deceptive and misleading fund names. The SEC has requested that comments be received by May 5, 2020.

- See **a copy of the SEC Comment Request**

Industry Update

Commissioner Allison Herren Lee Delivers Remarks before the Investment Adviser Association Compliance Conference 2020

On March 5, 2020, SEC Commissioner Allison Herren Lee delivered remarks at the Investment Adviser Association Compliance Conference 2020. Commissioner Lee first noted that the views expressed by her in her remarks are her views and not the views of her fellow Commissioners or the SEC staff. Commissioner Lee then focused her remarks on her priorities for her time as a Commissioner, which she addressed in the context of what she views as the SEC's core mission–to protect, serve and empower investors.

Investment Adviser Advertising

Commissioner Lee first focused on the protective purpose of the SEC's investment adviser advertising rules, noting that they are "designed generally to protect investors from false and misleading marketing." She remarked that "marketing materials provide useful information to investors as they select or retain an investment adviser, but, given the complexity of an adviser's services, the [SEC's] rules must ensure that such materials are accurate, contain appropriate content for the intended audience, and provide investors with sufficient information and context to make an informed decision."

Commissioner Lee then discussed the SEC's proposed rule change to the advertising rules. She noted that the proposal would "modernize much of the existing framework" and "address the presentation of adviser performance in a more holistic fashion." Commissioner Lee remarked that she views the proposal as a meaningful improvement as it "includes protective measures designed to ensure that investors are not misled; it updates and modernizes the regulatory regime to reflect the changing ways in which investors receive and review information; and it requires advisers, in certain contexts, to provide specific information to facilitate more informed decision-making."

Commissioner Lee then discussed two areas of the proposals that she believes merit additional thought. First, Commissioner Lee noted that the emphasis on a principles-based approach to certain of the rule's requirements may result in rules that are "too broad or vague" and that may end up "circumscribing conduct that [the SEC] would not intend to capture. Commissioner Lee continued by noting that she believes that "the current proposal may rely too heavily on high-level principles … "

Second, Commissioner Lee noted that she supports the effort in the proposal to "specifically engage with and receive input from both investors and small investment advisers through the use of questionnaires" as this approach provides them the opportunity to respond to questions relevant to them rather than more onerous requests for comment. Commissioner Lee remarked that she is in support of refining this approach to be used for investor testing for future rulemakings.

Climate Risk Disclosure

Commissioner Lee then focused on the SEC's "vital role" in serving investors and the growing call from investors for improvements in the SEC's disclosure regime to address "climate change and its attendant risks." Commissioner Lee noted that there is "overwhelming investor demand for consistent, reliable, and comparable disclosure around climate risk" and that the lack of such disclosure "undermines investors' and investment professionals' ability to evaluate the relevant risks when making investment decisions, and thus undermines efficient capital allocation."

Commissioner Lee continued that while, in response to the growing call for increased climate risk disclosure, "most large public companies supply some form of sustainability disclosure," investors "have been clear that the existing, largely voluntary disclosures are insufficient to meet their needs." Commissioner Lee noted that such voluntary disclosures lack uniformity and "the comparability necessary for meaningful investment analysis" by investors and that she will "continue to advocate that the [SEC] address climate change risk through both rulemakings and guidance in order to better serve investors."

Proxy Reform

Commissioner Lee last focused on the SEC's goal of empowerment so that investors are "empowered to hold the stewards of their capital accountable for the decisions they make and the strategies they pursue" by discussing the proxy process and the SEC's recently released proxy proposals.

The two proxy proposals released in November, Commissioner Lee said, will, in her view, "disempower investors." Investor feedback from those who rely on proxy advisors on the proposed amendments to the exemptions from the proxy rules for proxy voting advice, Commissioner Lee noted, has suggested that the proposed rule would "operate to increase costs, reduce reliability, and potentially reduce overall shareholder voting."

Commissioner Lee went on to criticize the proposal as lacking evidence of a real problem, stating that the proposal provides no objective evidence and fails to examine the validity of the allegations that "proxy advisor recommendations contain errors sufficient in number and scope to warrant a rulemaking." She continued by indicating that the proposal's premise that "these alleged errors would be reduced by mandating greater influence from a plainly conflicted party–the issuer" is implausible because issuers have "deep expertise and insight" on proxy ballot issues but also have a "clear stake in the outcome." Finally, Commissioner Lee noted that she believes that the proposal "presents risks to the exercise of shareholders' voting rights because the "costs, delays and unreliability" introduced into the proxy voting process by the proposal may result in investment advisers feeling "compelled to abstain from voting altogether, thus stifling investors' voices in corporate democracy." Such an outcome, Commissioner Lee remarked, "is clearly not in the best interest of investors."

Commissioner Lee concluded her remarks by reiterating her belief that every endeavor undertaken by the SEC "should focus on whether [the SEC] is protecting, serving and empowering investors."

- **See a transcript of her remarks**

SEC Disapproves Proposed Rule Change to Permit Listing and Trading of Shares of United States Bitcoin and Treasury Investment Trust

On February 26th, the SEC issued an order (the "**Order**") rejecting a proposed rule change to allow a national securities exchange to list and trade shares of the United States Bitcoin and Treasury Investment Trust (the "**Trust**"). The proposal, filed by NYSE Arca, Inc. and sponsored by Wilshire Phoenix Funds, if approved, would have allowed the public trading of the Trust, an investment vehicle holding bitcoin and short-term U.S. Treasury bills. The Trust's pricing mechanism would have relied on the Chicago Mercantile Exchange's Bitcoin Reference Rate, which is based on a volume-weighted median price sourced from certain bitcoin spot market venues.

In the Order, the SEC concluded that the applicants had not met the requirement under Section 6(b)(5) of the Securities Exchange Act of 1934, as amended (the "**Exchange Act**") that the proposal be designed to prevent manipulation and to protect investors and the public interest. Specifically, the SEC noted that, under its standard for evaluating this requirement, the applicants had failed to demonstrate the existence of a surveillance-sharing agreement with a regulated market of significant size or alternatively, establish that the underlying market was "uniquely" and "inherently" resistant to manipulation.

Commissioner Hester M. Peirce issued a dissenting statement (the "**Dissent**"), which criticized the SEC's decision and similar prior orders of disapproval. In the Dissent, Commissioner Peirce noted that these disapprovals require sponsors to respond to an ever-shifting standard—one that seems to require increasingly granular analyses of the relevant markets. Additionally, the Dissent argues that this heightened standard of review is inappropriate because it is at odds with the SEC's authority under the Exchange Act, which is to protect market quality, rather than to evaluate the merits of a particular investment product.

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

Litigation

SEC Settles with Investment Adviser for Engaging in Unauthorized Principal Trades

On February 24, 2020, the SEC issued an order (the "**Lone Star Order**") instituting and settling cease-and-desist proceedings against Lone Star Value Management ("**Lone Star**") and Jeffrey Eberwein ("**Eberwein**"), Lone Star's sole managing member, CEO, portfolio manager and sole owner, arising out of alleged undisclosed principal trades he engaged in without client consent.

According to the SEC, Eberwein began Lone Star and created the "Investors Fund," a fund managed by Lone Star, in October 2013. Between 2013 and 2014, Eberwein invested around $35 million of his own money into the Investors Fund, and over the course of a year, received funds from approximately thirty-nine other investors. In early 2014, Eberwein created the Co-Invest II Fund, and a few months later received funds from around nineteen investors. The SEC alleged that in August 2014 and November 2014, while reporting to the SEC as an exempt reporting investment adviser, Lone Star effected nineteen interfund cross trades between the Investors Fund and the Co-Invest II Fund. The SEC further alleged that in June 2015, while registered with the SEC as an investment adviser, Lone Star also effected two trades between the Investors Fund and a separate account Lone Star managed.

According to the Order, because Eberwein owned more than 35% of the Investors Fund at all times, these twenty-one trades were considered "principal trades." In addition, the SEC alleged that Lone Star never disclosed the trades in writing to the funds, or the funds' investors, and Lone Star never received client consent to make the trades. By engaging in these transactions without disclosing to its clients in writing that Lone Star was acting as a principal for each of the transactions and without receiving client consent for the transactions, Eberwein caused Lone Star's violations of Section 206(3) of the Advisers Act. Moreover, according to the Order, Lone Star also failed to implement written policies and procedures "reasonabl[y] designed to satisfy the written disclosure and client consent requirements" of Section 206(3) of the Advisers Act, after Lone Star became a registered investment adviser.

As a result of the conduct described above, the SEC found that Lone Star willfully violated, and Eberwein caused Lone Star's violations of, Section 206(3) and 206(4) of the Advisers Act, and Rule 206(4)-7 thereunder. As a result, Lone Star agreed to pay a civil monetary penalty of $100,000, consented to the entry of the Order, and agreed to cease and desist from future violations. Eberwein agreed to pay a civil monetary penalty of $25,000, and also consented to the entry of the Order and agreed to cease and desist from future violations.

- **See a copy of the Lone Star Order**

SEC Sues Investment Advisers for Alleged Failures to Disclose Financial Conflicts of Interest

On February 12, 2020, the SEC sued a former registered investment adviser, Criterion Wealth Management Insurance Services, Inc. ("**Criterion**"), and its principals Robert Gravette ("**Gravette**") and Mark MacArthur ("**MacArthur**"). The SEC, in its complaint, alleges that Criterion, Gravette, and MacArthur failed sufficiently to disclose their conflicts of interest for investment recommendations made to their clients and breached their fiduciary duties by recommending that their advisory clients invest more than $16 million in four private funds without disclosing that the fund managers for those investments had paid them more than $1 million in compensation in connection with these recommendations.

The SEC alleges that from 2012 to 2017, Criterion recommended that clients invest in a series of real estate investment funds offered by a fund manager ("**Fund Manager A**"), the principals of which were former colleagues and social acquaintances of MacArthur. In 2015 and 2016, Criterion allegedly recommended that clients invest in two real estate investment funds offered by another fund manager ("**Fund Manager B**"), the principals of which were longtime social acquaintances of both Gravette and MacArthur. According to the SEC, Criterion invested a substantial portion of client funds under its discretionary management in private investments.

The complaint alleges that MacArthur and Gravette negotiated arrangements with Fund Manager A and Fund Manager B to obtain payments in exchange for investing Criterion clients' assets into the fund managers' real estate investment funds. According to the SEC, Fund Manager A and Fund Manager B reduced the profit participation that Criterion investors would otherwise have received for two of the funds in order to pay the agreed compensation to Criterion and its principals, such as by placing Criterion's clients in separate share classes that paid lower returns to offset the cost of the payments to Criterion. Criterion also negotiated arrangements to receive referral fees that continued to pay out over time based on the amount of capital invested by Criterion clients. The SEC alleges that the investment advisers knew that these compensation arrangements would result in lower investment returns for their clients yet did not disclose that fact, or any other details of the arrangements, to their clients.

The SEC complaint was filed in the U.S. District Court for the Central District of California. The complaint charges Criterion, Gravette, and MacArthur with violating the antifraud provisions of Sections 206(1) and 206(2) of the Advisers Act. The SEC complaint also charges Criterion and Gravette with violations of Section 207 of the Advisers Act, and Criterion with violations of Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder. Gravette and MacArthur are charged with aiding and abetting Criterion's violations of Sections 206(1) and 206(2) of the Advisers Act and Gravette is charged with aiding and abetting Criterion's violation of Section 207 of the Advisers Act. The SEC is seeking permanent injunctions from future violations of these provisions, disgorgement and prejudgment interest, and civil penalties from all defendants.

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

SEC Obtains Judgment Against Former Chief Compliance Officer of Investment Adviser

On January 30, 2020, the United States District Court for the Northern District of Illinois entered a final judgment against David Goulding, the former Chief Compliance Officer of The Nutmeg Group. In 2019, following a two-week trial, the SEC obtained a judgment against Randall Goulding, the owner and managing member of The Nutmeg Group (and David Goulding's father) for violations of the Advisers Act arising out of Randall Goulding's misappropriation of investor funds.

In its January 21, 2020 order, the court found that David Goulding aided and abetted Nutmeg's violations of the Advisers Act, including by helping The Nutmeg Group commingle investor funds with personal assets, misleading investors about the value of their investments, and transferring money to companies controlled by his family. The court also found that Goulding acted recklessly by serving as Chief Compliance Officer despite "his complete lack of qualifications for that job." The court also entered a final judgment against two of Goulding's companies, David Goulding, Inc. and David Samuel, LLC, for receiving ill-gotten gains from his and Randall Goulding's misconduct.

As a result of the conduct described above, the court ordered Goulding to pay a total of $28,935 in disgorgement and prejudgment interest. The SEC previously enjoined him from violating the antifraud provisions of Sections 204, 206(1), 206(2), and 206(4) of the Advisers Act, and barred him from associating with any registered investment adviser.

- **See a copy of the Goulding Final Judgment SEC Release**

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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