Investment Management Regulatory Update

October 23, 2018

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Rules and Regulations

SEC Staff Grants No-Action Relief to the Independent Directors Council Under Rules 10f-3, 17a-7 and 17e-1 Under the Investment Company Act of 1940

On October 12, 2018, the Division of Investment Management of the Securities and Exchange Commission (the "**SEC**") issued a no-action letter (the "**Letter**") to the Independent Directors Council granting assurance that it would not recommend enforcement action for violations of Sections 10(f), 17(a) and 17(e) of the Investment Company Act of 1940, as amended (the "**Investment Company Act**"), for failure to obtain required board of director determinations under Rules 10f-3, 17a-7 and 17e-1 (the "**Exemptive Rules**"), so long as the board of directors receives a written representation at least quarterly from its chief compliance officer ("**CCO**") that any transactions entered into pursuant to the Exemptive Rules were made in compliance with policies adopted by the board.

Section 10(f) of the Act prohibits funds from acquiring any security (other than a security of which the fund is an issuer) during the existence of an underwriting or selling syndicate where a principal underwriter of the security is an officer, director, advisory board member, investment adviser or employee of the fund (or an affiliate of the foregoing). Rule 10f-3 exempts certain securities purchases from the prohibitions of Section 10(f).

Section 17(a) of the Act prohibits certain principal transactions between a registered investment company and its affiliates. Rule 17a-7 provides an exemption for certain cross-trades that would otherwise be prohibited under Section 17(a).

Section 17(e)(2)(A) generally prohibits an affiliated person of a fund (or an affiliate of such affiliate) from receiving certain brokerage fees beyond the customary commission received as a broker for effecting a sale of securities to or by the fund or any controlled company thereof. Rule 17e-1 thereunder provides that for purposes of Section 17(e)(2)(A), a commission, fee or other remuneration shall not be deemed to exceed the customary commission provided certain requirements are met.

According to the incoming letter (the "**Incoming Letter**"), each of the Exemptive Rules requires a board to "(i) adopt procedures that are reasonably designed to provide that the transactions comply with the conditions of the Exemptive Rule, (ii) make and approve such changes to those procedures as the board deems necessary and (iii) determine no less frequently than quarterly that all transactions made pursuant to the Exemptive Rule for the preceding quarter were effected in compliance with such procedures." According to the Incoming Letter, the SEC later adopted Rule 38a-1 under the Investment Company Act, requiring funds to adopt and implement compliance policies that would prevent violations of federal securities laws, which include the Exemptive Rules. According to the Incoming Letter, Rule 38a-1 requires the board to approve the compliance policies initially as well as approve the designation of a chief compliance officer to be responsible for administering the policies and procedures.

According to the Incoming Letter, the requested relief would allow boards of directors to receive a written representation from the CCO stating that transactions effected in reliance on Rules 10f-3, 17a-7 or 17e-1 under the Investment Company Act "complied with the procedures adopted by the board pursuant to the relevant Exemptive Rule, instead of the board itself determining compliance." The requested relief would align the requirements of the board under the Exemptive Rules with the compliance role assigned by the SEC under Rule 38a-1. According to the Incoming Letter, the Exemptive Rules contemplated that the board was the "first line of responsibility for determining compliance" with the rules; Rule 38a-1, however, "provided fund boards with direct access to a single person with overall compliance responsibility for the fund." According to the Incoming Letter, the proper role of a modern board of directors is to exercise oversight of the compliance program without becoming overly involved in day-to-day operations, while the CCO can in turn keep the board apprised of compliance issues.

In the Letter, the SEC agreed that the position taken in the Incoming Letter was consistent with the SEC's approach in adopting Rule 38a-1 and would allow boards of directors to avoid duplicating functions commonly performed by a CCO. Moreover, the SEC indicated that granting such relief would better facilitate a board's ability to focus on conflicts of issues concerns raised by affiliate transactions, "including whether a fund engaging in the types of affiliated transactions permitted by the Exemptive Rules is in the best interest of that fund and its shareholders."

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

Industry Update

Director of Division of Investment Management Testifies About Division Oversight

On September 26, 2018, Dalia Blass, Director of the Division of Investment Management (the "**Division**") of the SEC, testified before the United States House of Representatives Committee on Financial Services, Subcommittee on Capital Markets, Securities, and Investment in Washington, D.C.

Blass discussed how the asset management industry is critical to the U.S. economy and for the retirement and financial needs of "Main Street" investors. Blass stated that since her appointment in September

2017, the Division has embraced "three principles that guide [its] efforts in developing, assessing, and implementing policy initiatives: (1) improving the retail investor experience; (2) modernizing [the Division's] regulatory framework and engagement; and (3) leveraging [the Division's] resources efficiently."

Improving the Retail Investor Experience

Blass explored the initiatives of the Division aimed at improving the investment experience for Main Street investors.

1. Financial Professional Relationship: First, Blass discussed the Division's recommendation for a proposal that intends to help educate investors about whether they are dealing with a broker-dealer, an investment adviser, or both, and why that distinction matters when investors are considering employing a financial professional. For further discussion of the proposal, please see the May 7, 2018 Davis Polk Client Memorandum, **SEC Proposes Enhanced Standards for Advice to Retail Investors**. Under this proposal, Blass explained, firms would be required to provide investors with a new, succinct disclosure document (a "**Relationship Summary**"). The Relationship Summary would underscore the differences between broker-dealers and investment advisers, including requiring the disclosure of: "(1) the principal types of services offered; (2) the legal standards of conduct that apply to each; (3) the fees that the customer would pay; and (4) certain conflicts of interest that may exist." The Relationship Summary, according to Blass, would also include "key questions for investors to ask their financial professional."

   Second, Blass discussed the Division's recommendation for a proposed interpretation that she stated would "reaffirm and, in some cases, clarify the SEC's views on the investment adviser fiduciary duty standards."

   Emphasizing the importance of regulatory coordination and consistency, Blass stated that the Division has collaborated with the Division of Trading and Markets on the recommendation to "require a financial professional firm be direct and clear about whether it is a registered investment adviser, a registered broker-dealer, or both in its communications with investors and prospective investors." Blass stated that the proposed rules would also prevent standalone broker-dealers and their financial professionals from using the terms "adviser" and "advisor" as these terms may mislead prospective investors due to the similarity with the statutory term "investment adviser."

2. Modernizing Fund Disclosure: Blass discussed recent SEC releases which were based on the recommendations of the Division and "seek to improve the experience of Main Street investors considering fund investments." Blass mentioned that the SEC issued a request for public comment on ways to improve and modernize fund disclosures, and noted that the comment period ends on October 31, 2018.

   Blass spoke about the new rule adopted by the SEC that creates an optional "notice and access" method for delivering fund shareholder reports. Fund shareholders can currently receive a shareholder report in two ways: (1) paper through the mail or (2) electronically. Blass explained that the new Rule 30e-3 permits a third option: posting the shareholder reports "on a website that is free of charge and sending investors multiple notices in paper through the mail letting them know that the report is available either on the website or in paper." For a further discussion of new Rule 30e-3, please see the **June 28, 2018 Investment Management Regulatory Update**. Blass also mentioned the SEC's request for public comment on the current framework for fees that intermediaries charge funds to deliver disclosure documents, such as fund shareholder reports, for which the comment period ends on October 31, 2018.

3. Variable Insurance Product Summary Prospectus: Blass also spoke about the Division's consideration of a recommendation for a proposal designed to "provide investors with more user-

friendly, layered disclosure about variable insurance products." Because variable insurance products are generally more complex than other retail investment products (due to combining investment and insurance features), Blass stated that the Division is considering recommending a new summary prospectus that would "help investors better understand these products' costs and risks, and also produce cost savings that could be passed on to investors."

Modernizing the Division's Regulatory Framework and Engagement

Next, Blass discussed modernizing the regulatory framework and the Division's engagement with market participants in light of reviewing existing policies and approaches and determining whether they are efficient, effective, and appropriate.

1. Exchange-Traded Funds ("**ETFs**"): Blass emphasized the need for modernization of the regulation of the $3.6 trillion ETF market because it "is currently operating under more than 300 individually issued exemptive orders, which have varied over time in wording and terms." In light of this, Blass argued for a clear regulatory regime. She discussed the SEC's proposed new rule, which is aimed at replacing the process of granting individual orders for exemptive relief. She added that the proposal is designed to create a "consistent, transparent, and efficient regulatory framework for the types of ETFs that routinely receive exemptions today and to facilitate greater competition and innovation among ETFs." Blass stated that a final rule for routine ETF relief should enable the Division to focus more of its resources on requests for exemptions that "represent the next generation of potential developments" under the Investment Company Act. For a further discussion of the ETF proposal, please see the **July 31, 2018 Investment Management Regulatory Update**.

2. Covered Investment Fund Research Reports: Blass discussed the SEC's recently proposed rules and amendments that are intended to "reduce obstacles to providing research on investment funds in furtherance of the congressional mandate of Fair Access to Investment Research (FAIR) Act of 2017." She stated that the proposed rules would synchronize the treatment of investment fund research with research on other public entities under certain conditions, which Blass stated would promote research on "mutual funds, ETFs, registered closed-end funds, business development companies, and similar covered investment funds and provides investors with greater access to research to aid them in making investment decisions." Blass noted that the Division is reviewing comments from the public on the proposal as it prepares its recommendation for the SEC for adoption. For a further discussion of the recently proposed rules and amendments, please see the **June 28, 2018 Investment Management Regulatory Update**.

3. Offering Modernization for Business Development Companies ("**BDCs**") and Closed-End Funds: Blass next discussed the Division's efforts to develop rule recommendations that are consistent with congressional mandates, including pursuant to the Small Business Credit Availability Act and the Economic Growth, Regulatory Relief, and Consumer Protection Act, in order to modernize the way BDCs and closed-end funds are offered. For a further discussion of the Small Business Credit Availability Act, please see the **April 30, 2018 Investment Management Regulatory Update**.

4. Use of Derivatives by Registered Funds and BDCs: Blass discussed how the current regulatory framework for funds' use of derivatives has developed on "an instrument-by-instrument basis over many years," and is now based on a "general statement of policy in 1979, and over 30 staff no-action letters and other guidance that followed." Blass noted the 2015 exemptive rule proposal aimed to "address the use of derivatives and financial commitment transactions by registered funds and BDCs." For a further discussion of the 2015 derivatives proposal, please see the December 29, 2015 Davis Polk Client Memorandum, **SEC Proposes New Limits on Registered Funds' Derivatives Use**. She noted that the Division is now considering a recommendation that

the SEC re-propose a new rule designed to enhance and modernize the regulatory framework for registered investment companies' use of derivatives.

5. Amendments to the Marketing Rules Under the Investment Advisers Act of 1940 (the "**Advisers Act**"): Blass next stated that "registered investment advisers are subject to a rule governing marketing that has not changed significantly since its adoption in 1961." However, she noted that the asset management market, technology, and the types of investors that investment advisers serve have all evolved. Blass further added that since the landscape has evolved, the Division is considering recommendations for the SEC to modernize this rule. The Division is also considering recommendations for changes to the rule governing payments for soliciting business on behalf of registered investment advisers, a rule that was adopted in 1971.

6. Fund Board Outreach Initiative: Blass next acknowledged that fund directors' responsibilities have increased significantly over the years and that the Division has "established a new initiative to holistically revisit the responsibilities of fund boards." The Division, in coordination with the SEC's Office of the Chief Accountant, is considering recommendations for updates to SEC guidance on the valuation of portfolio securities and other assets held by registered funds and BDCs. Blass highlighted that the Division "seeks to modernize guidance to fund boards on performing their responsibilities concerning valuation in a way that recognizes" the evolution in the markets and the standards for accounting, auditing, and reporting.

7. Investment Company Liquidity Disclosure: Blass emphasized the importance of the management of fund liquidity by the fund adviser and discussed the 2016 rule that was "designed to promote effective liquidity risk management practices among open-end funds." Blass discussed the efforts of the SEC staff as well as fund sponsors towards implementation of the Rule 22e-4, noting that in February 2018 the SEC extended the compliance date for the classification elements of the rule and that the SEC recently adopted targeted amendments to the public reporting requirements of the rule. Blass underscored that these amendments are designed to enhance the fund disclosure regarding liquidity risks and comparability of certain fund liquidity metrics. For a further discussion of the amendments to the liquidity disclosure rules, please see the **July 31, 2018 Investment Management Regulatory Update**.

8. Fund Innovation and Cryptocurrency-Related Holdings: Blass next spoke about the importance of fund sponsors' innovation and improvement to the success of the U.S. investment fund market, particularly given how many Main Street investors rely on registered funds to meet their financial goals. Blass discussed the Division's history of supporting fund innovation and efforts to engage in a dialogue with fund sponsors on product innovation, including with respect to cryptocurrency-related holdings. She noted that the Division published a letter identifying some questions that the Division and Blass believe "need to be examined for funds to invest in crypto-related holdings in a manner consistent with the substantive requirements of [1940 Act] and its rules." She further explained that the letter discussed valuation, liquidity, custody, arbitrage for ETFs, and potential manipulation of cryptocurrency markets.

9. Review of the Proxy Process: Blass discussed how SEC Chairman Jay Clayton announced a staff roundtable on the proxy process to provide the staff an opportunity to "engage with investors, issuers, and other market participants on topics including the voting process, retail shareholder participation, and the role of proxy advisory firms." She also discussed how in connection with this announcement, the Division staff has been considering whether prior staff guidance on "investment advisers' responsibilities in voting client proxies and retaining proxy advisory firms should be modified, rescinded, or supplemented." Blass further noted that the Division has recently reexamined two such no-action letters, Egan-Jones Proxy Services (May 27, 2004) and Institutional Shareholder Services, Inc. (Sept. 15, 2004), and determined to withdraw both letters. For a further discussion of the Division's staff withdrawal of the two no-

action letters, please see the **September 28, 2018 Investment Management Regulatory Update**.

Leveraging the Division's Resources Effectively

Blass finally discussed the Division's efficient use of resources, which is "critical to [its] ability to serve American investors and develop informed policy in today's dynamic asset management space."

1. Use of Data and Analytics: Blass spoke about how the Division is committed to increasing the efficiency and effectiveness of its regulatory programs through the enhanced use of technology and data analysis. Blass specifically mentioned that the "staff in the Division's Analytics Office has advanced [the Division's] ability to interpret data, to focus [its] resources, and to respond with rigor to questions about asset management." Blass mentioned an internal tool that the Division uses called "MAGIC," which is an acronym for Monitoring and Analytics Graphical User Interface for Investment Companies. Blass spoke in more detail about this tool, noting that she expects "this tool to help [the Division] to implement a risk-based approach to reviewing disclosure that will improve the effectiveness and efficiency of [its] work." According to Blass, the Division is also exploring the use of technology-based tools to improve the efficiency of the Division's internal processes.

2. Process Improvements: Blass mentioned that the Division continues to make efforts to improve the efficiency and effectiveness of the Division's internal processes. According to Blass, in order "to better focus [its] resources, the staff generally takes a risk-based approach to reviewing disclosure filings, devoting particular focus to (1) filings by novel and complex funds; (2) new disclosures; and (3) disclosures that most directly influence investment decisions, such as disclosures on investment strategies, risks, fees, and performance." The Division has also been working to improve the transparency of its fund disclosure review process.

3. Human Capital Planning: Finally, Blass spoke about how the asset management market continues to evolve and stated that, as a result, the Division's staffing must also adapt. More specifically, Blass mentioned that "it is vital to [the Division's] mission that the Division recruits not just lawyers, but individuals with background as financial analysts, accountants, traders, and even salespeople who want to use their real-world experience in the investment management business to help protect investors." Blass noted that human capital is one of her highest priorities as Director.

- **See a transcription of the testimony**

Co-Director of SEC Enforcement Steven Peikin Gives Remarks on Remedies and Relief in SEC Enforcement Actions

On October 3, 2018, Steven Peikin, Co-Director of the Division of Enforcement (the "**Division**") of the SEC, presented a speech entitled "Remedies and Relief in SEC Enforcement Actions" at the PLI program White Collar Crime 2018: Prosecutors and Regulators Speak, in New York. In the speech, Co-Director Peikin reflected on the Division's work over the past year and its priorities for the upcoming year.

During his speech, Co-Director Peikin noted quantitative metrics, such as the number of enforcement actions brought by the SEC and the amount of penalties and disgorgement ordered by the SEC or federal district courts, provide only a "rough measure" of SEC activity but "do not provide a full and meaningful picture of the quality, nature, and effectiveness of [the SEC's] efforts."

Co-Director Peikin stated that rather than focusing on quantitative metrics, he and Co-Director Stephanie Avakian consider certain questions when assessing whether the Division's work is effective in accomplishing the SEC's mission, including:

1) Are the SEC's efforts protecting retail investors?

2) To what extent is the SEC holding individuals accountable for violations of the law?

3) Is the SEC keeping pace with technological change?

4) Do the remedies the SEC recommends effectively further enforcement goals?

5) Is the SEC efficiently allocating the Division's resources?

In his speech, Co-Director Peikin focused on the question of how particular remedies and relief that the Division recommends to the SEC advance the SEC's goals. He noted that while financial penalties are important to an enforcement regime because "they punish wrongdoers and send a message of general deterrence," a "case-specific" approach to remedies and relief is also important. Co-Director Peikin stated that when determining the appropriate relief in a given case, the Division is guided by the following questions: "Does the relief punish bad actors and restore money to harmed investors? Does it advance the goals of specific and general deterrence? And does it put into place meaningful protections for investors going forward?"

Co-Director Peikin noted that crafting the appropriate relief often requires leveraging forms of non-monetary, equitable relief and identified (i) undertakings and conduct-based injunctions and (ii) bars and suspensions, as two of the most effective forms of equitable relief in SEC enforcement actions. Co-Director Peikin stated that undertakings require a defendant to "take affirmative steps" to comply and remain in compliance with the terms of a court order, and conduct-based injunctions prohibit a defendant from "engaging in conduct that, while otherwise legal, poses risk of harm to investors in the future." Co-Director Peikin noted these remedies are available in civil injunctive actions and similar obligations can be imposed through administrative and cease-and-desist proceedings.

Co-Director Peikin identified a settlement with Billy McFarland as one recent example of a conduct-based injunction. According to the SEC's complaint, McFarland fraudulently induced more than 100 investors to invest over $27 million in his companies, including Fyre Festival LLC. In addition to full disgorgement, the final judgment included a conduct-based injunction that enjoined McFarland from directly or indirectly participating in the issuance, purchase, offer or sale of securities, except for his own personal account.

Co-Director Peikin then proceeded to discuss undertakings. He noted that undertakings are a "forward-looking remedy," adding that many undertakings require the settling party to retain a compliance consultant or monitor that makes recommendations to the company and reports to the SEC on terms defined in the settlement. He further noted that this allows SEC actions "to seed changes in a corporation's processes in a way that serves the long-term interests of investors." Co-Director Peikin also stated that undertakings are effective because they can be tailored to accomplish remedial objectives "specific to the wrongful conduct at issue."

Co-Director Peikin then discussed several recent examples of enforcement actions involving undertakings, including actions against Theranos, Inc. ("**Theranos**") and Tesla, Inc. ("**Tesla**"). With respect to the Theranos matter, he noted that the SEC charged the company and its CEO, Elizabeth Holmes, with raising over $700 million from investors in a "scheme involving exaggerated claims about the company's technology, business, and financial performance." According to Co-Director Peikin, the SEC's settlement with Holmes included undertakings that required her to relinquish her voting control over Theranos and guaranteed that in a liquidation event, Holmes would not profit from her ownership stake until $750 million had been returned to other investors. He noted that these undertakings protected investors from "potential misuses" of the CEO's controlling stake.

Co-Director Peikin then discussed the SEC's recent settlement with Tesla and its CEO and Chairman, Elon Musk. The SEC charged Musk with fraud for tweeting false and misleading statements about plans to take Tesla private, and charged Tesla with failing to maintain disclosure controls and procedures with respect to Musk's communications. Co-Director Peikin noted that in addition to financial penalties, the settlement included undertakings that, if approved by the court, will require: (i) Musk to resign as Chairman and be replaced by an independent Chairman; (ii) Tesla to add two independent directors to the board; (iii) Tesla to form a committee of independent directors and adopt controls and procedures to oversee Musk's public communications about the company; and (iv) Tesla to employ an experienced securities lawyer within its legal department. Co-Director Peikin emphasized that the undertakings were "specifically targeted" to address specific risks raised by the facts and circumstances of the matter.

Co-Director Peikin next noted that the SEC can impose other forward-looking or remedial measures, including officer and director bars and associated bars and suspensions. He stated that bars and suspensions "serve a critical prophylactic function – preserving the integrity of our markets and protecting investors by limiting the activity of known bad actors by removing them from the industry or preventing them from serving as officers or directors at public companies." He identified several bars the SEC has obtained in settlements during this fiscal year, including, among others, against the former CEO of LendingClub Asset Management LLC and against Elizabeth Holmes of Theranos. Co-Director Peikin acknowledged that bars can be a "resource-intensive remedy" for the SEC because many individuals choose to litigate rather than settle, but stated that bars, like undertakings, can have "direct, far-reaching, and positive effects for investors."

Co-Director Peikin then proceeded to discuss civil penalties and disgorgement. Discussing the rationale behind financial penalties, Co-Director Peikin stated that the SEC is charged with promulgating and enforcing rules governing certain business practices of the entities it regulates, and that penalties are "one of the primary enforcement tools" the SEC has to "incentivize regulated entities to remain in compliance with the rules that protect investors." Co-Director Peikin also noted that the analysis for corporate issuers with a class of securities registered with the SEC may involve additional considerations, because such issuers are required to make public filings and "using enforcement to promote the integrity of issuers' public filings – which are central to the sound functioning of our capital markets – is a critical part of [the SEC's] mandate." Co-Director Peikin noted that in determining whether to recommend penalties, the Division considers whether application of the "Seaboard" factors is appropriate, including evaluation of (i) the nature of the remedial steps taken by the company; (ii) the company's self-reporting and self-policing efforts; and (iii) the extent of its cooperation with the SEC and law enforcement. Co-Director Peikin then identified various matters over the last year where the Division recommended substantial penalties against corporate issuers. He also stated that "not every case warrants a penalty," and cited an SEC order from last December where the Division did not recommend a penalty because the company had taken extensive remediation efforts in response to the CEO and CFO receiving millions of dollars in undisclosed perks.

Co-Director Peikin next discussed disgorgement, which he noted is handled differently than penalties. Co-Director Peikin stated that "even where a defendant or respondent cooperates and agrees to meaningful undertakings, it should not be entitled to keep its ill-gotten gains." He stated that in cases of offering frauds in particular, where individuals obtain money from investors through fraudulent representations, "disgorgement is a central component of meaningful relief and often the surest way to restore at least a portion of investors' losses." Co-Director Peikin also discussed the United States Supreme Court's ruling in *Kokesh v. SEC* ("**Kokesh**") that disgorgement is to be considered a penalty for statute of limitation purposes, and thus proceeds of misconduct obtained by a wrongdoer outside the statute of limitations are insulated from disgorgement. He stated that Kokesh led the SEC to forego seeking approximately $800 million in potential disgorgement, and added that this number will continue to rise.

Co-Director Peikin concluded by re-emphasizing the Division's case-specific approach to recommending remedies and relief and stating that the effectiveness of the SEC's enforcement program cannot be measured by any one quantitative measure, "but instead requires a nuanced and qualitative evaluation of our overall impact on achieving our investor and market integrity protection mission."

- **See a copy of the speech**

Litigation

SEC Sues Investment Adviser, Manager for Alleged "Short and Distort" Scheme

On September 12, 2018, the SEC filed a complaint (the "**Lemelson Complaint**") against Gregory Lemelson ("**Lemelson**") and Lemelson Capital Management, LLC ("LCM") in the U.S. District Court for the District of Massachusetts. The SEC alleges that Lemelson and LCM engaged in a fraudulent scheme in which Lemelson took "short positions" in the stock of Ligand Pharmaceuticals, Inc. ("**Ligand**") and then sought to manipulate the stock price by disseminating false statements about Ligand to drive down the stock price.

According to the Lemelson Complaint, from May 2014 until October 2014, Lemelson took short positions in Ligand stock through his hedge fund The Amvona Fund, LP ("**Amvona**"), for which LCM acted as investment manager and adviser. Beginning in May 2014, Lemelson and LCM took an initial short position in Ligand of 579 shares on behalf of Amvona. Shortly thereafter, Lemelson allegedly published a variety of false and misleading statements about Ligand, including that its flagship product was "going away"; that Ligand's relationship with another pharmaceutical company was an "affiliated shell company" that Ligand used to "create almost a veritable pyramid scheme of shell companies" that was "guaranteed to lose money"; that Ligand had a "debt to equity ratio of 11,667 to 1"; and that "Institutional Holders waste no time dumping stock" of Ligand. The SEC alleged that Lemelson either knew that all of these statements were false or made them with reckless disregard for their truth or falsity.

According to the SEC, Lemelson disseminated these false and misleading statements by writing and publishing multiple "research reports" that he distributed to the press, participating in both live and written interviews about Ligand, and posting about Ligand on different social media websites and various other media outlets. Lemelson also took affirmative steps to suppress commentary highlighting his bias, lack of familiarity with Ligand, and his motivation to drive down Ligand's stock price.

In addition to deceiving the public by making false statements, the SEC also claimed that Lemelson and LCM deceived and misled Amvona investors, and prospective investors, both by publicizing false statements about Ligand and by not disclosing that Amvona's positive returns from its short position in Ligand were tied to his stock price manipulation.

The SEC alleged that in the wake of Lemelson's negative reports and interviews regarding Ligand, Ligand's share price had dropped from $68.72 to $51.75 in just three months. The SEC has indicated that in total, Lemelson sold short 77,836 shares of Ligand in 2014, allowing Amvona to profit roughly $1.3 million from the trading. The SEC alleged that Lemelson and LCM violated Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and Section 206(4) of the Investment Advisers Act of 1940 (the "**Advisers Act**") and Rule 206(4)-8 thereunder, and that Amvona's gains from the trading should be disgorged or that a constructive trust should be imposed on such gains. The SEC seeks injunctive relief, disgorgement, and civil penalties.

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

Federal District Court Concludes that Virtual Currencies Are Commodities Subject to the CFTC's Jurisdiction

On September 26, 2018, Senior Judge Rya W. Zobel of the U.S. District Court for the District of Massachusetts issued a decision in *CFTC v. My Big Coin Pay, Inc*., further confirming the power of the Commodity Futures Trading Commission ("**CFTC**") to prosecute fraud involving virtual currencies. The decision affirmed the CFTC's position that all virtual currencies, and not just Bitcoin or other virtual currencies for which there is an active futures market, are commodities that fall within the agency's jurisdiction.

The decision arises from an action brought by the CFTC on January 16, 2018, against a virtual currency company, My Big Coin Pay, Inc., (“**My Big Coin**”) and its founder and lead salesman, Randall Crater, for allegedly making material misrepresentations or omissions concerning the value and financial backing of the virtual currency My Big Coin in violation of Section 6(c)(1) of the Commodity Exchange Act (“**CEA**”) and CFTC Regulation 180.1(a). Defendants allegedly falsely represented that My Big Coin was “backed by gold,” could be used anywhere MasterCard was accepted, and was being “actively traded” on several currency exchanges. In addition, the defendants allegedly fabricated and arbitrarily changed the price of My Big Coin to mimic the fluctuations of a legitimate, actively-traded virtual currency. As a result of this fraudulent scheme, the defendants allegedly obtained more than $6 million from purchasers of My Big Coin.

Defendants moved to dismiss, arguing principally that the CFTC lacked jurisdiction to bring the case since My Big Coin is not a “commodity” within the meaning of the CEA. The CEA defines a “commodity” as a variety of specific products and “all other goods and articles, except onions . . . and motion picture box office receipts . . . and all services, rights, and interests . . . in which contracts for future delivery are presently or in the future dealt in.” Defendants argued that My Big Coin is not a “commodity” subject to the CEA because My Big Coin did not underlie any futures contracts. However, the court rejected this argument, ruling that Congress intended for the CFTC to regulate products categorically, not as individual items or types.

Judge Zobel rejected defendants’ argument and held that the term “commodity” under the CEA is broader than any particular “type or brand” of that commodity. Pointing to cases that rejected the same argument regarding “types” of natural gas, Judge Zobel held that so long as any virtual currency is the subject of futures contracts—and the parties did not dispute that Bitcoin futures are actively traded and that many courts have concluded that Bitcoin is a commodity—other types of virtual currencies are also “commodities” subject to the CEA even if those types of virtual currencies do not underlie futures contracts.

Judge Zobel’s ruling further confirms the CFTC’s regulatory jurisdiction over the virtual currencies market, and strengthens the CFTC’s ability to pursue false and misleading virtual currency schemes.

- **See a copy of the decision**

SEC Settles with Voya Financial Advisors, Inc. for Failing to Adopt and Implement Sufficient Policies to Prevent Identity Theft

On September 26, 2018, the SEC issued an order (the “**VFA Order**”) instituting and settling proceedings against Voya Financial Advisors, Inc. (“**VFA**”), an Iowa-based investment adviser and broker-dealer, for allegedly failing to adopt written policies and procedures reasonably designed to protect customer records and information and for failing to develop and implement a sufficient identity theft prevention program.

According to the VFA Order, in April 2016, certain intruders fraudulently gained access to the personally identifiable information (“**PII**”) of at least 5,600 VFA customers by impersonating VFA independent contractor representatives on phone calls to VFA’s service call centers. VFA’s independent contractor representatives managed VFA’s customers’ brokerage accounts through a proprietary web portal, and VFA permitted independent contractor representatives to access the web portal using their own technology systems. While VFA had implemented policies and procedures to protect customer records, the SEC alleged that these policies were not reasonably designed to apply to independent contractor access. For example, the SEC alleged that VFA allowed its contractors to maintain concurrent sessions, did not apply a “15-minute timeout” rule that terminated access to the systems, and did not have a procedure for remotely terminating a representatives’ session. VFA outsourced its cybersecurity and some of its information technology functions to its parent company, which serviced the web portal and provided technical support for both VFA customers and VFA independent contractor representatives through service call centers.

According to the VFA Order, over six days, these call centers received fraudulent requests to reset three of VFA's representatives' passwords for the web portal. The call centers provided temporary passwords over the phone, and on two occasions also provided the representatives' usernames, allowing access to the web portal and access to VFA's customers' PII. Once the fraudulent activity was detected, VFA took steps to respond to the intrusion, but failed to prevent the intruders from gaining access to the portal by impersonating two additional representatives and failed to terminate the intruders' access to the portal even after VFA realized that access had been improperly granted.

Based on the conduct described above, the SEC alleged that VFA willfully violated Rule 30(a) of Regulation S-P, which requires broker-dealers and investment advisers to adopt written policies and procedures reasonably designed to safeguard customer records and information. The SEC also alleged that VFA violated Rule 201 of Regulation S-ID, which requires certain broker-dealers and investment advisers to develop and implement a written "Identity Theft Prevention Program" that is designed to detect, prevent, and mitigate identity theft. Without admitting or denying the charges, VFA agreed to pay a civil monetary penalty of $1 million to cease and desist from future violations, to be censured, and to engage an independent consultant to review VFA's policies and procedures and make recommendations deemed necessary to bring such policies and procedures into compliance with applicable requirements.

The VFA Order serves as yet another reminder that broker-dealer and investment adviser cybersecurity remains a focus of the Office of Compliance Inspections and Examinations ("**OCIE**") and is among OCIE's announced "exam priorities," and that OCIE "will prioritize cybersecurity with an emphasis on, among other things, governance and risk assessment, access rights and controls, data loss prevention, vendor management, training, and incident response."[1]

In order to assist our clients with the increasingly complex web of cybersecurity and privacy regulations, we have created the ***Davis Polk Cyber Portal****—a secure online suite of tools—to help our clients meet their breach notification obligations, as well as other cybersecurity and privacy regulatory requirements. The Portal includes, among other resources, guidance for general counsel on their role in cybersecurity and regulatory compliance, model cybersecurity policies, procedures and incident response plans, and summaries of recent cybersecurity cases, statutes, industry guidance and regulatory actions.*

Clients can request access by visiting the Cyber Portal website at ***www.dpwcyberportal.com*** *or emailing* ***cyberportal@davispolk.com****. We are happy to provide clients with a demonstration of the platform and trial credentials for 30 days. If you have questions about the Cyber Portal, please contact* ***Avi Gesser*** *or* ***Will Schildknecht****. We also update clients on the latest cybersecurity and privacy legal developments at* ***https://www.dpwcyberblog.com/***.

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

Putnam Investments and Portfolio Manager Zachary Harrison Settle with SEC for Prearranged, Undisclosed RMBS Cross-Trades Favoring Certain Advisory Clients

On September 27, 2018, the SEC announced its settlement (the "**Putnam Order**") with Putnam Investment Management, LLC ("**Putnam**"), and Zachary Harrison ("**Harrison**"), a former portfolio manager and residential mortgage-backed securities ("**RMBS**") trader in Putnam's Structured Credit Group, for undisclosed, prearranged cross-trades that favored certain advisory clients over others. The SEC alleged that, on dozens of occasions between April 2011 and September 2015, Harrison arranged to temporarily sell securities to particular broker-dealers at the highest or only bid price received and

[1] *See* Securities Exchange Commission, Office of Compliance Inspections and Examinations, 2018 National Exam Program Examination Priorities, at 9, *available at* **https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2018.pdf**.

indicated his intention to that buyer that he intended to repurchase the securities the next business day at a small markup. As alleged by the SEC, Putnam's insufficient monitoring efforts did not detect these cross-trades.

According to the Putnam Order, Putnam was required at various times to sell RMBS positions on behalf of one or more registered investment company clients because of market conditions, client investment objectives, portfolio guidelines, liquidations, or redemptions. In cases where Harrison otherwise viewed the RMBS investment as desirable, he would arrange to sell to third party broker-dealers, often using particular code words, with the understanding that he would be able to repurchase on behalf of other registered investment company clients at a small markup the following business day. Investment Company Act Rule 17a-7 requires, among other things, that cross-trades be executed at the independent current market price, or "the average of the highest current independent bid and lowest current independent offer, determined on the basis of reasonable inquiry." The SEC alleged that Harrison would often deal with the same two broker-dealers without attempting to sell the securities into the market, in what the SEC alleges was a way to avoid applicable regulatory requirements and cause Putnam's client to repurchase securities at prices only slightly above the bid prices at which they were sold. Harrison's interposing of broker-dealers to effect prearranged cross-trades led to prices more favorable to Putnam's repurchasing clients than the prices that would have resulted if risk had actually been passed from Putnam's clients to the broker-dealers. The benefit of these more favorable prices was entirely allocated to Putnam's buying clients, depriving the selling clients of their share of the market savings generated by Harrison's practices.

The SEC noted that as a result of this conduct, both Putnam and Harrison caused certain Putnam advisory account clients to violate Sections 17(a)(1) and 17(a)(2) of the Investment Company Act. These sections make it unlawful for any "affiliated person or promoter of or principal underwriter for a registered investment company or any affiliated person of such a person, promoter or principal underwriter, acting as principal (1) knowingly to sell any security or other property to such registered investment company or to any company controlled by such registered investment company, or (2) knowingly to purchase from such registered investment company, or from any company controlled by such registered investment company, any security or other property," unless the transaction complies with the exemptive requirements contained in Rule 17a-7 under the Investment Company Act, or the adviser obtains an exemptive order under Section 17(b) of the Investment Company Act. The SEC added that Putnam had not sought an exemptive order and that the transactions did not comply with the exemptive requirements of Rule 17a-7 "because the trades were not executed at a price equal to the average of the highest current independent bid to purchase that security and the lowest current independent offer to sell that security, and were made through one or more broker-dealers who received remuneration in connection with the transactions."

Additionally, the SEC charged Putnam with violating Section 206(2) of the Advisers Act, which prohibits any investment adviser from "engaging in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." The SEC further charged Putnam with violating Section 207 of the Advisers Act, which "makes it unlawful for any person willfully to make any untrue statement of a material fact in any registration application or report filed with the [SEC], or willfully to omit to state in any such application or report any material fact which is required to be stated therein." The SEC alleged that Part II of Putnam's Form ADV contained materially false statements regarding the cross-trades. The SEC also alleged that Putnam violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which requires, among other things, "that registered investment advisers adopt and implement written policies and procedures reasonably designed to prevent violations, by the investment adviser and its supervised persons, of the Advisers Act and rules," since Putnam failed to adopt and implement policies and procedures reasonably designed to ensure compliance with the cross-trading prohibitions. According to the Putnam Order, Harrison also alleged caused Putnam's violations of Section 206(2) and Putnam failed to reasonably supervise Harrison within the meaning of Section 203(e)(6) of the Advisers Act.

Putnam and Harrison, without admitting or denying the findings, agreed to civil penalties of $1 million and $50,000, respectively. Additionally, Harrison agreed to a suspension from "association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization or from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter for a period of nine months…."

In determining to accept this settlement offer, the SEC considered remedial acts undertaken by Putnam, including its retention of a compliance consultant, changes to policies and procedures on cross-trading, launching of an internal investigation, and its voluntary placement of over $1 million in escrow to compensate harmed clients.

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

SEC Settles with LendingClub Asset Management for Undisclosed Conflicts of Interest, Return Adjustment, in Connection with Investments in LendingClub Loans

On September 28, 2018, the SEC issued an order (the "**LendingClub Order**") instituting and settling administrative cease-and-desist proceedings against LendingClub Asset Management ("**LCA**"), an investment adviser affiliated with LendingClub Corporation ("**LendingClub**"), an online marketplace lending company, LCA's former president Renaud Laplanche ("**Laplanche**"), and LCA's former CFO, Carrie Dolan ("**Dolan**"). LCA allegedly (i) caused one of its advised private funds to purchase interests in loans to benefit LendingClub, rather than LCA's investor clients, and (ii) adjusted monthly returns for certain advised private funds to improve reported returns in certain months.

LendingClub, LCA's parent, offers a platform to match borrowers seeking consumer loans and investors who wish to purchase securities backed by those loans. LCA advises certain private funds that invest in interests in loans listed for sale on LendingClub's platform. LCA disclosed to investors in its advised private funds that potential conflicts of interest might arise out of its relationship with LendingClub, and informed investors that it would create and maintain an "ethical wall" between LCA and LendingClub.

According to the LendingClub Order, in late 2015 investor demand for 60-month loan interests declined, and LendingClub faced the prospect that a large number of 60-month loan interests listed for sale risked expiring unfunded. LCA allegedly caused one of its managed funds to exclusively purchase interests in 60-month loans, even though the purchases would cause the number of 60-month loans held in the fund's portfolio to exceed allocation limits and despite the availability of 36-month loan interests that were not at risk of expiring unfunded. According to the LendingClub Order, although certain LCA officers objected and questioned whether such purchases violated fiduciary duties to LCA's clients, the managed fund continued to purchase 60-month loan interests until March 2016. The SEC alleges that LCA failed to disclose to investors that LCA was laboring under a conflict of interest and had caused its advised funds to purchase 60-month loan interests to benefit LendingClub.

LCA also allegedly applied improper adjustments to return data to improve published returns. The LendingClub Order notes that since the LendingClub loans lacked observable market valuation inputs, FASB ASC 820 authorizes the loans to be valued based on management estimates or pricing models. The LendingClub Order states that LCA's pricing model permitted adjustments to allow for "supportable bases," such as changes in loss trends, which were not directly incorporated by model inputs. LCA allegedly further adjusted returns by applying basis point "floors" for monthly returns in December 2015 and January 2016, and, in March 2016, by applying prospectively a contemplated change in interest rates to a certain category of LendingClub loans even though the rate change had not yet gone into effect. These adjustments allegedly resulted in the managed funds' reporting positive returns when unadjusted returns would have been negative or near zero.

Based on the conduct described above, the SEC alleged that LCA, Laplanche, and Dolan violated Section 206(1) of the Advisers Act (which prohibits an investment adviser from employing any device, scheme or artifice to defraud any client or prospective client), Section 206(2) of the Advisers Act (which makes it unlawful for an investment adviser, directly or indirectly, to engage in any transaction, practice or course of business that operates as a fraud or deceit upon any client or prospective client), Section 206(4) of the Advisers Act and Rules 206(4)-7 and 206(4)-8 thereunder (which (i) require registered investment advisers to, among other things, implement written policies and procedures reasonably designed to prevent violation of the Advisers Act and the rules adopted thereunder; and (ii) make it unlawful for any investment adviser to a pooled investment vehicle to make "any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle" or "engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle," respectively), Section 207 of the Advisers Act (which makes it "unlawful for any person willfully to make any untrue statement of a material fact in any registration application or report filed with the [SEC] . . . or willfully to omit to state in any such application or report any material fact which is required to be stated therein"), and Section 204(a) of the Advisers Act and Rule 204-1(a) thereunder (which requires a registered investment adviser to amend its Form ADV as required by the instructions to Form ADV).

The SEC noted that LCA had self-reported the alleged violations following an investigation by LendingClub's board of directors, and that LCA implemented remedial measures including establishing a new governing board, reimbursing fund clients, outsourcing valuation to an independent third party, engaging a client consultant, and closing the managed funds. LCA agreed to notify its advisory clients, certify compliance with the order, and to pay a civil monetary penalty of $4 million. Laplanche agreed to cease and desist from further violations, to be barred from association with a variety of SEC-regulated entities, including investment advisers, and to be prohibited from serving or acting as an employee, officer, director, advisory board member, investment adviser, or underwriter of a registered investment company or affiliate, for at least three years, and to pay a civil monetary penalty of $200,000. Dolan agreed to be censured and to pay a civil monetary penalty of $65,000.

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

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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