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EXAMINATIONS

Recent Experiences With SEC Examinations and Enforcement: Cybersecurity, BCPs, Branch Offices and Disclosures (Part One of Two)

By Charlie Marlow, *Hedge Fund Law Report*

Although SEC examination and enforcement priorities remain relatively steady over time, with every new administration and SEC Chair come subtle shifts in focus areas and approaches. A recent seminar hosted by Brian T. Davis and Dimitri G. Mastrocola, partners at international recruiting firm Major, Lindsey & Africa, examined how SEC examination and enforcement efforts are shaping up under Chair Gary Gensler. The program featured Scott H. Moss and Eileen Overbaugh, partners at Lowenstein Sandler.

This first article in a two-part series distills their insights on cybersecurity, business continuity plans, branch offices and disclosures. The second article will present their thoughts on the use of the word "may" in disclosures; conflicts of interest-related issues; cross trades and principal transactions; insider trading; responsible investing; and exams of new advisers.

See our two-part coverage of the SEC's 2021 examination and enforcement priorities: "Cybersecurity, Business Continuity and Conflicts of Interest" (Jul. 22, 2021); and "ESG, New Marketing Rule and Other Potential Focuses" (Jul. 29, 2021).

Recent Trends

In recent months, the SEC Division of Examinations (Examinations) has been covering "a really large range of topics . . . focus[ing] on anything and everything," Moss said. At the same time, however, Examinations appears to be much more willing to resolve "even harsh deficiencies or issues" without a referral to the Division of Enforcement (Enforcement), which was not always the case. Moreover, Enforcement has been "much more selective" in choosing the matters it pursues, he noted.

Given the broad range of areas covered on exams, advisers should be prepared for many highly detailed follow-up questions, especially in the areas of material nonpublic information, information flow, custody and valuation, Moss continued. Examinations is also looking closely at whether advisers are doing what they say they are going to do, which "may sound really simple but is harder in practice," he said. Examinations will test an adviser's assertions.

See "SEC Compliance and Enforcement Expectations for Private Funds Under Chair Gensler" (Oct. 7, 2021); and our two-part series "Practical Guide for Private Fund Managers Navigating SEC Exams in the Biden/Gensler

Era": Part One (Jul. 8, 2021); and Part Two (Jul. 15, 2021).

"If you take one thing away from this panel, it is to update your risk assessment and your conflicts assessment," Moss advised. Do not wait for the annual compliance review. "Do it now because risks change and the SEC will no longer forgive a lag between business changes and compliance operations," he stressed.

See "First 100 Days As GC/CCO: Managing Daily Work, Performing Risk Assessments and Looking Ahead (Part Three of Three)" (May 13, 2021); and "Use a Risk Assessment Template to Take a Thoughtful Approach to Compliance" (Apr. 23, 2020).

Cybersecurity and Vendor Review

Cybersecurity is now absolutely essential and "permeates the very existence of every single registered investment adviser," Moss said. Examinations will focus on an adviser's risk assessment, which is the starting point of any cybersecurity program. Once an adviser has identified the relevant risks, it must address those risks in its program and conduct appropriate monitoring.

See our three-part series on how fund managers should structure their cybersecurity programs: "Background and Best Practices" (Mar. 22, 2018); "CISO Hiring, Governance Structures and the Role of the CCO" (Apr. 5, 2018); and "Stakeholder Communication, Outsourcing, Co-Sourcing and Managing Third Parties" (Apr. 12, 2018).

Although many advisers are returning to their pre-pandemic work regimes, many employees continue to work from home. The electronic platforms that facilitate remote operations have become the new normal, Moss continued. Protecting them is essential. Most firms rely on technology vendors for those platforms, making those vendors increasingly important. Thus, advisers must conduct extensive due diligence on them.

See "A Checklist for Fund Managers to Ensure Adequate Vendor Management" (Sep. 9, 2021); and our two-part series on drafting data privacy and security provisions in vendor agreements: "Assessing the Risks" (Apr. 1, 2021); and "Negotiating Critical Provisions and Responding to Incidents" (Apr. 8, 2021).

Cybersecurity is one area in which an examination can lead to enforcement, Moss cautioned. Three recent enforcement actions concerned cloud-based email. The SEC claimed that the respondent advisers did not really understand the risks of cloud-based email and lacked sufficient security. The advisers in question had either identified the need for two-factor authentication in their risk assessments or their programs required it. In each case, however, the adviser allegedly failed to implement it, which was one of the factors that tipped the scales in favor of an enforcement referral.

For more on those enforcement actions, see "Fund Managers Must Ensure Adequate Security Measures Under Safeguards Rule or Risk SEC Enforcement Action" (Sep. 30, 2021).

Enforcement actions are not limited to failures that result in harm, Moss added. It used to be "no harm, no foul," and a failure that did not result in a breach was unlikely to result in an enforcement action. Enforcement no longer waits for harm, however. A security gap can lead to an enforcement action, even if the gap was not exploited.

See our two-part series on SEC cybersecurity disclosure enforcement: "Recent Developments" (Oct. 7, 2021); and "Best Practices" (Oct. 14, 2021).

Business Continuity Plans

The SEC has been looking at how well advisers' business continuity plans (BCPs) functioned during the coronavirus pandemic, Overbaugh observed. The concept of business continuity has changed as a result of the pandemic, Moss explained. For example, many BCPs provided that, if the office lost power, employees would work from home using remote access and their cellphones. Now, however, the home office has become the main office for many individuals. Thus, BCPs should now address what happens if a home loses power. The SEC is looking at how advisers are addressing this new normal.

See "OCIE Risk Alert Highlights Concerns Associated with Coronavirus Pandemic" (Sep. 10, 2020); "Are You Prepared for OCIE's Sweep of Business Continuity Plans and Coronavirus Actions?" (Jul. 30, 2020); and our two-part series on the key elements of hedge fund adviser business continuity and disaster recovery plans: "Business Continuity Plans" (Feb. 17, 2010); and "Disaster Recovery Plans" (Feb. 25, 2010).

"One of the things that was really risky [in examinations] was using COVID as an excuse," Moss added. There is nothing wrong with saying the coronavirus pandemic interfered with business, provided the adviser had a plan to deal with the disruption and followed it. On the other hand, "be very careful about using COVID as a reason for a delay or a reason for something that didn't go well," if that is not the true reason, he advised. "[T]he SEC will pick that up and run with it" and scrutinize the adviser's pandemic-related disclosures, he cautioned. In many cases, it is better simply to admit, "We messed up."

See "Recent Case Illustrates How Not to Respond When SEC Examiners Voice Concerns" (Feb. 6, 2020).

Branch Office Issues

The SEC offered temporary relief at the outset of the pandemic for branch offices, but those working conditions have become the new normal, Overbaugh said. The temporary relief provided that an adviser did not have to list temporary pandemic-related work-from-home arrangements as branch offices in its Form ADV, Moss explained. Once an arrangement becomes permanent, however, it must be disclosed. An adviser can check a box on its Form ADV to indicate that an address is a home address, in which case the address will be redacted from the public version of the form, he noted.

See "ACA Briefing: Regulatory Responses to Coronavirus Pandemic and Best Practices for Business Continuity and Compliance" (Apr. 16, 2020).

The NFA went further than the SEC, offering permanent relief for home offices that are not held out to the public or to investors as an office, Moss continued. Hopefully, the SEC will follow the NFA's lead. In the interim, advisers must be prepared to list home offices on Form ADV.

Advisers should also be wary of differences between tax analysis and SEC analysis, Moss cautioned. Some advisers may claim that certain home offices are permanent residences to take advantage of lower tax rates in certain states while claiming to the SEC that those branches are temporary.

"One way or another, all those home offices are going to be branch offices that have to be supervised as such, which includes books and records and record destruction," Moss advised. Advisers have less control over those processes and must train employees accordingly. It appears that supervision of home offices has been more important on exams than whether home offices are listed on Form ADV, he noted. Specifically, examiners have been concerned about cybersecurity, login procedures, technology vendors and books and records management.

An adviser must list every office where "advisory business is conducted," Moss explained. Thus, an adviser definitely must disclose the home offices of investment personnel who are working remotely. An adviser may also have to disclose the home offices of back-office personnel, depending on their particular functions.

See "SEC Risk Alert Focuses on Multi-Branch Investment Advisers" (Jan. 14, 2021); and our three-part series on the duty to supervise: "Recent SEC Enforcement Actions Claim Violations by Broker-Dealers and Investment Advisers" (Sep. 6, 2018); "Conduct Proper Trade and Electronic Communications Surveillance" (Sep. 13, 2018); and "Respond to Red Flags; Implement Reasonable Policies and Procedures; and Conduct Adequate Training" (Sep. 20, 2018).

Disclosures

The SEC's settled enforcement action against Monomoy Capital Management, LP involved several "classic" compliance errors, Overbaugh explained. Notably, the adviser allegedly failed to disclose that it was charging fees to portfolio companies that it was not offsetting against management fees. The SEC also took issue with the fact that the adviser updated its Form ADV after the fund closed. A key lesson from the settlement is that, if an adviser discovers a conflict or needs to enhance disclosure of a conflict, it should do so in both its private placement memorandum (PPM) and its Form ADV prior to the fund closing. Many advisers look at Form ADV updates as an "ordinary course" exercise, but they should consider whether an interim update may be needed, she said.

See "Troutman Pepper Attorneys Examine SEC Enforcement Trends" (Mar. 11, 2021); "SEC Continues to Scrutinize Accelerated Private Equity Monitoring Fees" (Aug. 23, 2018); and "SEC Continues Scrutiny of Undisclosed Fees at Fund Managers" (Jun. 7, 2018).

The PPM is the most critical disclosure document for advisers that offer commingled funds, Moss said. On the other hand, Form ADV tends to be the primary disclosure document for advisers to managed accounts, because managed accounts do not have a PPM and may not have a limited partnership or operating agreement. Thus, Form ADV is secondary for fund managers, while the PPM is the most critical disclosure document. In fact, the SEC has indicated that an adviser's Form ADV may point to risk factors detailed in a PPM.

The materiality of the matter to be disclosed is critical, Overbaugh continued. It might be acceptable to wait for the annual Form ADV amendment to enhance an existing disclosure. On the other hand, if an adviser is making a material change to a disclosure or a significant change to its business, it would be prudent to update Form ADV at the same time as the PPM. An amendment after the fact to reflect a material matter will probably not pass muster with the SEC, Moss concurred.

If an examiner asks why a disclosure was not included in an adviser's Form ADV and the adviser can show that the disclosure was already in the PPM, the adviser could get a pass because the PPM is the critical offering document, Moss added. Examinations may still say "get it in the ADV," but that will resolve the issue.

See "SEC Sanctions Adviser for Undisclosed Conflicts and Misleading Form ADV" (Jun. 3, 2021); and our two-part series "Practical Lessons From OCIE's Risk Alert on Compliance Issues for Private Fund Managers": Part One (Nov. 19, 2020); and Part Two (Dec. 3, 2020).

December 16, 2021

DISCLOSURE

Recent Experiences With SEC Examinations and Enforcement: Disclosures, Conflicts and Trading Issues (Part Two of Two)

By Charlie Marlow, *Hedge Fund Law Report*

The SEC's mission is to protect investors; maintain fair, orderly and efficient markets; and facilitate capital formation. That mission does not change with new administrations or new Chairs, but specific focus areas or strategies may evolve with a changing of the guard. Brian T. Davis and Dimitri G. Mastrocola, partners at international recruiting firm Major, Lindsey & Africa (MLA), recently hosted a seminar that explored how SEC examination and enforcement efforts are shaping up under Chair Gary Gensler. The program featured Scott H. Moss and Eileen Overbaugh, partners at Lowenstein Sandler.

This second article in a two-part series presents their perspectives on the use of the word "may" in disclosures; conflicts of interest-related issues; cross-trades and principal transactions; insider trading; responsible investing; and exams of new advisers. The first article distilled their insights on cybersecurity, business continuity plans, branch offices and disclosures.

For coverage of another MLA seminar, see "Anticipating SEC and CFTC Enforcement Priorities Under the Biden Administration" (Mar. 18, 2021).

The Dreaded "May"

The SEC has been taking action against advisers that use "the dreaded 'may'" to describe a practice that they already engage in, especially fee and expense practices, Overbaugh said. Thus, as an adviser makes ordinary-course updates of its private placement memoranda (PPMs), Forms ADV and other disclosure documents, it "really should be spending some time on those 'may,' 'could,' [and] 'might' disclosures and thinking about whether it is actually happening at the firm currently," she advised. Those errors are low-hanging fruit for examiners and are easy to remedy.

It is easy to search for those problematic terms, Moss noted. "And, 'may' is still okay if something really is forward-looking," he said. For example, on one exam, examiners took issue with an adviser's use of "may" with regard to a particular fee because the adviser had, in fact, already taken the fee in certain instances. Moss pushed back, stressing that the adviser used the term "may" because it took the fee only in certain circumstances. The adviser still received a deficiency letter but resolved the deficiency by disclosing that it had taken the fee in certain circumstances and the situations when it would take the fee in the future. The

SEC position resulted in better disclosure, but it did not mean that the adviser's use was totally inappropriate. "It should really be clear in the PPM and the ADV when you actually do something, if you have actually done it and when you might do it in the future," Moss advised.

See "Adviser and CCO Sanctioned for Undisclosed Conflicts; Custody Rule Violations; and Deficient Policies and Procedures" (Oct. 14, 2021); and "SEC Continues Crackdown on Use of 'May' in Disclosures" (Nov. 14, 2019).

Conflicts-of-Interest-Related Issues

The SEC remains focused on valuation and allocation of investment opportunities and expenses because of the "really, really obvious conflicts" they present, Moss said. Risk assessments are critical, "because if you don't know a conflict is there, you can't deal with it," he said. The SEC expects specificity in disclosures. If a disclosure is not sufficiently specific, any ambiguity must be interpreted in the light most favorable to the fund.

Valuation

An adviser's valuation of unrealized gains directly affects its compensation, Moss explained. In addition, valuation presents conflicts when investors enter and exit a fund. If a manager is overly conservative in its valuations, it could hurt investors who are leaving the fund.

The SEC has also begun to scrutinize valuations of illiquid "Level 3" assets. Although there is a big band of reasonableness in GAAP as to what fair value is, the SEC has not shied away from testing fair value and testing valuation procedures, Moss said.

See "SEC Enforcement Action Accuses Fund Auditor and Partners of Widespread Failures Valuing Level 3 Assets and Lack of Independence" (Sep. 9, 2021); "HFLR Program Explores Valuation of Illiquid Assets and Valuation Governance" (Jan. 28, 2021); and our two-part valuation series: "Crises May Require Deviation From Usual Procedures" (Nov. 5, 2020); and "Five Steps to Take When Deviating From Usual Procedure" (Nov. 12, 2020).

Expenses

Moss noted that expenses are "a zero-sum game" – either the adviser or one or more of its funds must pay them. The PPM should disclose what constitutes a fund expense, what constitutes an adviser expense and what methodology is used for allocating expenses between them. Form ADV can be used to expand on expense allocation practices as they evolve during the life of a fund. Expense disclosure "used to be three sentences; now it's three pages," Overbaugh remarked.

See "SEC Fines Fund Manager for Failing to Equitably Allocate Fees and Expenses to Its Affiliate Funds and Co-Investors" (Jun. 6, 2019); "Absent Proper Disclosure, Allocation of Manager Expenses to Funds May Bring Significant SEC Penalties" (Sep. 29, 2016); and our three-part series on fee and expense allocation practices: "Practices Fund Managers Should Avoid" (Aug. 25, 2016); "Flawed Disclosures to Avoid" (Sep. 8, 2016); and "Preventing and Remedying Improper Allocations" (Sep. 15, 2016).

Soft Dollars

Soft dollars have also been a recurring issue, Moss said. A soft dollar arrangement creates a conflict of interest if an adviser has multiple clients but one of those clients generates a disproportionate amount of soft dollar credits.

The research generated by that client will benefit the adviser's other clients. Thus, advisers must disclose that soft dollars will benefit clients that do not generate them.

See "ACA Panel Reviews Rules Related to Aggregation of Publicly Traded Securities, Best Execution, Soft Dollars, Portfolio Holding Liquidity and Gifts (Part Two of Two)" (Sep. 13, 2018).

Co-Investments

Co-investments have been on the SEC's radar for several years, Overbaugh said. Historically, they were used primarily by venture capital and private equity advisers. As hedge fund advisers adopt hybrid models that allocate a portion of assets under management to private deals, they also may have the opportunity to offer co-investments.

After the adviser to a hybrid fund builds its portfolio, it may have unused deal capacity and may wish to use co-investment vehicles to take advantage of those opportunities, Overbaugh explained. Consequently, hybrid fund advisers are adding disclosures about the conflicts associated with co-investments to their PPMs and establishing the criteria and process for selecting co-investors. Advisers that are contemplating offering co-investment opportunities should be thoughtful about it from the outset.

See "SBAI Issues Guidance on Conflicts, Valuation and Structuring for Private Credit Fund Managers and Investors (Part One of Two)" (Aug. 6, 2020).

Many advisers do not have clear processes for selecting co-investors, Moss added. The process can be very subjective, and "it's easy to pick something that benefits the manager," such as an investor that can offer additional capital or better information flow, he noted. The subjective nature of the process and lack of transparency make co-investments an area that is ripe for increased SEC scrutiny. Advisers must be careful in how they describe the process.

To address those concerns, some PPMs disclose that the adviser has full discretion over whether to have co-investments and how to allocate them, Overbaugh said. When reviewing those types of disclosures, the SEC might still expect to see discussion of some objective criteria. Those types of disclosures also put more pressure on compliance departments to document the selection process and why the manager chose a particular investor, Moss added. If examiners ask to see an adviser's co-investment policy and the policy gives the adviser very broad discretion, the examiners will ask for communications pertaining to how co-investors were chosen.

For more on co-investments, see "The Global Hedge Funds Landscape: Accessing Non- U.S. Institutional Capital (Part One of Two)" (Jul. 8, 2021); and our three-part series on co-investments in the hedge fund context: "Pursuing Illiquid Opportunities While Avoiding Style Drift" (Feb. 21, 2014); "Structuring Considerations and Material Terms" (Feb. 28, 2014); and "Fiduciary Duty Concerns, Conflicts and Regulatory Risks" (Mar. 7, 2014).

Cross Trades and Principal Transactions

In 2021, the Division of Examinations (Examinations) issued its second risk alert since 2019 on cross trades and principal transactions, showing the SEC's continuing focus on that area, Moss said. Examiners routinely ask whether an adviser enters into cross trades or principal transactions. When evaluating cross trades, examiners will ask four fundamental questions:

1. Why was it good for the buyer?
2. Why was it good for the seller?
3. How did the adviser value the trade and obtain any requisite approvals?
4. What disclosures did the adviser make about the practice?

See "Pair of Risk Alerts Focuses on Issues Associated With Cross Trades, Principal Transactions and Wrap Fees" (Aug. 19, 2021); and "OCIE Risk Alert Details Concerns About Principal Transactions and Agency Cross Trades" (Oct. 24, 2019).

In addition, when a trade is a principal transaction, the adviser must obtain the client's prior informed consent, a process that will be governed by the fund documents. That usually entails obtaining consent from fund investors, an independent representative, a limited partner advisory committee or the fund's board. The process should be set forth clearly in the fund documents.

See "SEC Fines Investment Adviser for Improper Cross Trades and Principal Transactions" (Oct. 15, 2020); and "SEC Continues to Focus on Cross Trades and Principal Transactions" (Apr. 16, 2020).

MNPI and "Sympathy Trades"

Material nonpublic information (MNPI) remains a "huge focus" of both Examinations and the Division of Enforcement, Moss remarked. A "sympathy trade," also referred to as a "shadow trade," occurs when an adviser has confidential information about one company and trades in the shares of a second company in the same industry because the second company will be affected by that information. The SEC recently commenced its first civil enforcement action on that expanded interpretation of the misappropriation theory of insider trading. The agency's case is reasonably strong, in Moss' view. Consequently, advisers should consider expanding their MNPI policies and restricted lists.

See "'Shadow Trading' Theory of Insider Trading and the Implications for Private Fund Managers" (Sep. 23, 2021).

General insider trading policies are no longer sufficient in the eyes of the SEC, Moss continued. Advisers must identify all potential sources of MNPI – such as value-added investors, expert networks, alternative data and conversations with management – and address each of the identified areas. The possibility that a fund might be frozen out of trading due to MNPI concerns is becoming a standard risk factor in PPMs, Overbaugh added.

See our two-part series on current insider trading regulatory and enforcement environments: "SEC Information Gathering and Enforcement" (Jul. 8, 2021), and "Appropriate Policies and Procedures" (Jul. 15, 2021); as well as "Advisers Must Have Strong Insider Trading Controls or Risk SEC Sanctions" (Apr. 2, 2020); and "General Insider Trading Policies and Procedures May Be Insufficient for Hedge Fund Managers to Avert SEC Enforcement Action" (Nov. 3, 2016).

See also our two-part series on mitigating insider trading risk: "Relevant Laws and Regulations; Internal Controls; Restricted Lists;

Confidentiality Agreements; Personal Trading; Testing; and Training" (Sep. 27, 2018); and "Expert Networks, Political Intelligence, Meetings With Management, Data Rooms, Information Barriers and Office Sharing" (Oct. 11, 2018).

Responsible Investing

Driven by investor interest, managers are seeking to form funds that incorporate environmental, social or governance (ESG) factors or put an "ESG overlay" on existing funds, Overbaugh explained. It is now "the hottest topic and on the top of everyone's mind," she said.

Notwithstanding the SEC's public discussion of ESG, Examinations has not focused closely on it unless an adviser has made it a focus of its PPM, disclosures or website, Moss noted. In those instances, examiners focus on whether the adviser did what it said it was going to do. Consequently, an adviser should ensure that its ESG policy is coordinated with disclosures in its PPMs and other fund documents and document how it implemented those policies. "If you don't know if you did what you said you were going to do, then the SEC or an investor is not going to know either," he observed.

Eventually, the SEC will bring an enforcement action in this area, but it will involve "really egregious conduct," such as claiming to follow an ESG strategy but not doing anything on ESG, Moss said.

See our two-part series on the evolving SEC approach to ESG: "SEC Commissioners Peirce and Roisman Argue Against Prescriptive ESG Disclosures" (Oct. 21, 2021); and "SEC Commissioners Gensler and Lee Advocate Further SEC Oversight of ESG Efforts" (Oct. 28, 2021).

Disclosure of ESG risk factors depends on how ESG is used, according to Overbaugh. For an impact strategy, there will likely be dozens of risk factors. On the other hand, if ESG is just one consideration of many, there might be just a couple of associated risk factors. The starting point of disclosure is always what "ESG" means to the adviser.

An adviser must tread very carefully if an investor asks for a side letter in which the adviser commits to considering ESG factors or signing on to a responsible investing protocol. That is a very serious undertaking with serious implications for the business that could put the adviser "in a pot of trouble" on its next exam, Overbaugh cautioned.

See "Trends in Hot-Button Terms in Side Letter Negotiations, Including MFNs and ESG Considerations (Part Two of Two)" (Sep. 16, 2021).

See also our two-part series on the SEC's ESG risk alert: "Why the SEC Distinguishes ESG From Other Strategies and How to Prepare for a Potential Exam" (Jun. 24, 2021); and "Inadequate Controls, Policies and Procedures Concern SEC As Do ESG Practices Inconsistent With Disclosures" (Jul. 8, 2021).

Exams of New Advisers

New advisers should expect an exam within one or two years of their launches, Moss said. Those exams usually have a limited focus. Examiners will look for a "knowledgeable, competent and empowered" CCO and a reasonably tailored compliance program. A deficiency letter is the most likely outcome, but in his experience, Examinations has been issuing more "no further action" letters in the past couple of years.

The timing of the adviser's next exam is likely to turn on how well its initial exam went. If it went very badly, the adviser should expect a follow up within a year. Otherwise, it could be from two to ten years, depending on the risk score Examinations assigns to the adviser.

See our three-part series on tailoring a compliance program: "Why Fund Managers Should Customize" (Jul. 16, 2020); "What Fund Managers Should Consider" (Jul. 23, 2020); and "When Fund Managers Should Review and Update" (Jul. 30, 2020).