Private Equity Regulatory Update

August 31, 2020

COVID-19 Update

Please refer to Davis Polk's "**Coronavirus Updates**" webpage for content related to the outbreak.

Rules and Regulations

SEC Modernizes the Accredited Investor Definition

On August 26, 2020, the Securities and Exchange Commission (the "**SEC**") adopted amendments to the definition of "accredited investor" in Regulation D, and the definition of "qualified institutional buyer" in Rule 144A, under the Securities Act of 1933, as amended (the "**Securities Act**"). Davis Polk will publish a client memorandum discussing the amendments to the definition of "accredited investor" and "qualified institutional buyer."

Industry Update

OCIE Publishes Risk Alert on Select COVID-19 Compliance Risks and Considerations for Broker-Dealers and Investment Advisers

On August 12, 2020, the Office of Compliance Inspections and Examinations ("**OCIE**") issued a risk alert to share the OCIE's observations of COVID-19-related issues, risks and practices relevant to SEC-registered investment advisers and broker-dealers ("**Firms**"), as well as those caused by the market

volatility related to COVID-19 ("**Risk Alert**"). According to the Risk Alert, the OCIE has remained operational nationwide throughout the COVID-19 pandemic and has assessed the impacts of COVID-19 and operational resiliency challenges through its work with SEC registrants, outreach and exam efforts. The OCIE also noted that "market volatility related to COVID-19 may have heightened the risks of misconduct in various areas that the staff believe merit additional attention." The Risk Alert outlined the OCIE's observations and recommendations in six categories: (1) protection of investor assets; (2) supervision of personnel; (3) practices relating to fees, expenses and financial transactions; (4) investment fraud; (5) business continuity; and (6) the protection of investor and other sensitive information.

Protection of Investor Assets

Each Firm has a responsibility to ensure the safety of its investors' assets and to guard against theft, loss and misappropriation. The OCIE has observed that some Firms have modified their normal operating practices regarding collecting and processing investor checks and transfer requests, particularly when checks are mailed physically. The OCIE encourages Firms to review and modify their practices when they are not picking up mail daily and to update their supervisory and compliance policies and procedures to disclose that checks or assets mailed to the Firm's office may have delays in processing.

The OCIE also recommends that Firms review their policies around distributions to investors, "including where investors are taking unusual or unscheduled withdrawals from their accounts," and particularly with retirement accounts for COVID-19-related expenses. Firms may want to consider additional steps to validate the investor's identity and distribution instructions such as whether the person is authorized to make the request and ensure bank account names and numbers are accurate. Another consideration is recommending that each investor have a trusted contact person in place, particularly for vulnerable investors.

Supervision of Personnel

Firms have an obligation to supervise their personnel, with oversight of supervised persons' investment and trading activities. Firm's supervisory and compliance programs are tailored to each Firm's specific business activities and needs. The shift to Firm-wide telework from dispersed working locations, dealing with significant market volatility and responding to operational, technological and other challenges may have impacted the Firm's supervisory and compliance programs. The OCIE encourages Firms to closely review and modify their supervisory compliance policies and procedures where necessary. The OCIE identified a few issues that Firms may want to modify their practices to address:

- Supervisors may not have the same level of oversight and interaction with supervised persons.
- Supervised persons making securities recommendations in market sectors that have experienced greater volatility or may have heightened risks for fraud.
- The impact of limited on-site due diligence reviews and other resource constraints associated with reviewing of third-party managers, investments and portfolio holding companies.
- Communications or transactions occurring outside the Firms' systems due to personnel working from remote locations and using personal devices.
- Remote oversight of trading, including reviews of affiliated, cross and aberrational trading, particularly in high volume investments.
- The inability to perform the same level of diligence during background checks when onboarding personnel or to have personnel take requisite examinations.

Fees, Expenses and Financial Transactions

Firms have obligations relating to considering and informing investors about the costs of services and investment products and the related compensations received by Firms. The market volatility and resulting impact on investor assets and the fees that Firms collect may have increased financial pressures and may increase risk of potential misconduct. The OCIE specifically noted instances of financial conflicts of interest, such as recommending retirement plan rollovers into investment products that the Firm or their personnel are soliciting, borrowing or taking loans from investors and clients and making recommendations that result in higher cost to investors and greater compensation for supervised persons. Additionally, the OCIE flagged potential for misconduct regarding fees and expenses such as overbilling of advisory fees, inaccurate calculations of tiered fees and failures to refund prepaid fees for terminated accounts.

To address the potential for misconduct, the OCIE recommends that Firms review their fees and expense policies and consider enhancing their monitoring, particularly by (i) validating the accuracy of disclosures, and fee and expense calculations, (ii) identifying transactions that resulted in high fees and expenses to investors, monitoring such trends and evaluating whether they were in the best interest of investors and (iii) evaluating risks associated with borrowing or taking loans from investors, clients and other parties that create a conflict of interest. Additionally, if advisers seek financial assistance, they may need to update their disclosures on Form ADV Part 2.

Investment Fraud

In times of crisis or uncertainty, the OCIE has observed a heightened risk of investment fraud through fraudulent offerings. Firms should be aware of these risks when conducting due diligence on investments and in determining that the investments are in the best interest of investors, particularly with false and misleading claims relating to vaccines and cures for COVID-19 infections.

Business Continuity

Firms that are required to implement compliance policies designed to prevent violation of federal securities laws should consider their ability to operate critical business functions during emergency events. Since Firms are predominately remote, the transactions may raise compliance issues and other risks that could impact long-term remote operations.

First, the OCIE noted that Firms' supervisory and compliance procedures may need to be modified or enhanced to account for changes in business operations required to maintain business continuity and the unique risks and conflicts of interests in remote operations. For example, supervised persons may need to take on expanded roles in order to maintain continuity, which may create new risks not typically present or addressed in the supervisory and compliance policies.

The OCIE also addressed concerns about Firms' security and support for remote sites, which may need to be modified or enhanced. Issues that Firms should consider include whether (i) increased measures for securing servers and systems are needed, (ii) the integrity of vacated facilities is maintained, (iii) relocation infrastructure and support for personnel operating from remote sites is provided and (iv) remote location data is protected. These measures should be addressed in business continuity plans in order to ensure that key operations, key person succession plans and mission critical services to investors are not at risk.

Protection of Sensitive Information

Firms have an obligation to protect investors' personally identifiable information ("**PII**"). The OCIE has observed that many firms require videoconferencing and electronic means of communicating to continue their operations. These practices create vulnerabilities around the potential loss of sensitive information, including PII due to remote access to networks and the use of web-based applications, the increased use of personally owned devices and changes in control over sensitive documents printed at remote locations. Additionally, electronic communications provide more opportunities for fraudsters to use phishing and other means to improperly access systems and accounts.

OCIE recommends that Firms pay particular attention to the risks regarding access to systems, investor data protection and cybersecurity. In particular, Firms should assess their policies and procedures and consider:

- Enhancements to their identity protection practices, such as by reminding investors to contact the Firms directly by telephone for any concerns about suspicious communication;
- Providing Firm personnel with additional trainings related to phishing and cyberattacks, sharing information on remote systems, encrypting documents and destroying physical records at remote locations;
- Conducting heightened reviews of personnel access rights and controls as individuals take on new or expanded roles in order to maintain business operations. Using encryption technologies on all devices, including personally owned devices;
- Ensuring that remote access servers are secured effectively and kept fully patched;
- Enhancing system access security; and
- Addressing new or additional cyber-related issues related to third parties, which may also be operating remotely when accessing Firms' systems.
- **See a copy of the Risk Alert**

OCIE Issues Ransomware Alert

On July 10, 2020, the Office of Compliance Inspections and Examinations ("**OCIE**") issued a cybersecurity alert warning SEC registrants, including broker-dealers, investment advisers and investment companies, about the recent increase in the sophistication of ransomware attacks. As noted in the risk alert, ransomware is a type of malware that is designed to allow unauthorized access to an institution's system. The unauthorized user would then typically deny the institution's use of its own system and demand a ransom that must be paid for the institution to be able to regain control of its system and maintain the confidentiality of customer data. The OCIE has also observed ransomware attacks that have impacted service providers of such SEC registrants.

In light of these ransomware attacks, the OCIE urges registrants and other market participants to monitor the alerts issued by the Department of Homeland Security Cybersecurity and Infrastructure Security Agency ("**CISA**"), including the alert published on June 30, 2020 which highlights tactics and techniques used by these intruders as well as ways to mitigate risk.

Additionally, the OCIE has observed the following cyber defense practices being used by registrants:

- ***Incident response and resiliency policies, procedures and plans***, which entails "[a]ssessing, testing, and periodically updating incident response and resiliency policies and procedures, such as contingency and disaster recovery plans." These procedures may include (i) having a response plan in place, (ii) implementing procedures for the timely notification and response if an attack occurs, (iii) implementing procedures for addressing compliance with federal and state reporting requirements for cyber incidents and (iv) implementing procedures for the notification of law enforcement if an attack occurs.
- ***Operational resiliency, which entails*** "[d]etermining which systems and processes are capable of being restored during a disruption so that business services can continue to be delivered."
- ***Awareness and training programs***, which includes "[p]roviding specific cybersecurity and resiliency training, and considering undertaking phishing exercises to help employees identify phishing emails."

- ***Vulnerability scanning and patch management***, which entails "[i]mplementing proactive vulnerability and patch management programs that take into consideration current risks to the technology environment, and that are conducted frequently and consistently across the technology environment." These programs may include (i) ensuring all firmware, software and antivirus software have the most current updates and (ii) ensuring that antivirus software is set to automatically update in the future.
- ***Access management***, which entails managing user access through systems and procedures that (i) limit access, (ii) separate duties, (iii) recertify users' access on a periodic basis, (iv) require the use of strong passwords that are changed frequently, (v) utilize multifactor authentication and (vi) revoke access immediately for individuals no longer employed at the organization.
- ***Perimeter security***, which entails implementing security systems that are able to control and inspect all network traffic to prevent unauthorized traffic. This may include the use of firewalls, remote desktop protocols or intrusion protection systems.

The OCIE noted that cybersecurity has been a key examination priority for many years, and encouraged registrants to focus on information security as a key risk area.

- **See a copy of the Risk Alert**
- **See a copy of the June 30th CISA Alert**

Litigation

Investment Advisers Settle with SEC Regarding Alleged Misrepresentations About Payments Received for Customer Order Flow

On August 5, 2020, the SEC issued an order (the "**WBI Order**") instituting and settling cease-and-desist proceedings against WBI Investments, Inc. ("**WBI**"), an investment adviser, and Millington Securities, Inc. ("**Millington**"), an investment adviser and broker-dealer (collectively, "**Respondents**"), who provided brokerage services to WBI and certain of its clients, arising out of alleged misrepresentations regarding payments for order flow that Millington received for executing trades for WBI's clients.

WBI and Millington provided advisory services to a series of exchange traded fund ("**ETF**") and mutual fund clients. During this time, WBI was responsible for making investment decisions on behalf of these shared clients, while Millington acted as the primary introducing broker-dealer for orders placed by WBI on behalf of its clients. According to the SEC, Millington entered into arrangements with several unaffiliated broker-dealers ("**Executing Brokers**"), to execute orders for WBI's clients. This arrangement had two interrelated components: first, the Executing Brokers would pay Millington, as compensation for its role in effecting WBI's client trades, around $0.0125 per share for each executed stock trade and $0.0150 per share for each executed ETF trade; and, second, the Executing Brokers would execute WBI's client orders on a "net" basis—e.g., an Executing Broker would buy a security in the market for one price and then sell the security to Millington at a higher price. The difference between the two prices represented the Executing Broker's compensation for the trade—which, over time, would amount to $0.02 to $0.03 per share—and the net prices received by Millington were passed onto WBI's clients as part of the transaction price.

According to the SEC, WBI and Millington failed to fully disclose to clients that the payment for order flow arrangement had the effect of increasing the prices that WBI clients paid to execute trades. The WBI Order states that WBI and Millington generally disclosed to their clients, including through WBI's Form ADV, that Millington received payments for order flow, and that WBI would execute trades through Millington even if execution through an unaffiliated broker-dealer would result in more favorable prices or lower transaction costs. WBI and Millington also informed clients on a quarterly basis, the payment for

order flow rate paid to Millington and the amount of payment that Millington received on a trade-by-trade basis.

The SEC alleged, however, that WBI and Millington did not explain, until approximately May 2017, that as part of the payment for order flow arrangement, the Executing Broker would execute trades for WBI clients on a net basis and that this would affect the price at which client orders were executed. To the contrary, the SEC alleged, on several occasions WBI and Millington asserted to the boards of the advised funds that the payment for order flow arrangement did not affect the execution prices received by WBI and its clients. The SEC alleges that these misstatements violate Section 206(2) of the Advisers Act, and constitute a violation of Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder as WBI and Millington failed to adopt and implement policies and procedures reasonably designed to ensure that the information conveyed to clients about brokerage practices was complete and accurate.

Millington and WBI agreed to be censured, to cease and desist from further violations, and to pay civil monetary penalties in the amount of $250,000 and $750,000, respectively.

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

SEC Announces Charges Against Chief Executive Officer of Investment Adviser for Alleged "Multi-Year Effort to Fraudulently Inflate Value and Returns"

On August 11, 2020, the SEC filed a complaint in the U.S. District Court for the Central District of California against Brendan Ross ("**Ross**"), the owner and CEO of Direct Lending Investments, LLC ("**DLI**"), a registered investment adviser, for an allegedly fraudulent scheme to inflate the value and returns of an investment position held by certain funds that DLI advised.

According to the SEC's complaint, Ross founded DLI in 2012, and in 2016 registered DLI as an investment adviser. DLI allegedly managed two "feeder" funds and a "master" fund, with approximately $866 million in assets under management as of May 31, 2018. DLI principally invested in entities that provided loans. The SEC alleged that Ross drafted monthly investor letters sent to investors in DLI's managed funds, and that these letters focused on the funds' consistent positive returns.

The SEC alleges that one of the DLI funds' early investments was in QuarterSpot, Inc. ("**QuarterSpot**"), an online small business lender. DLI invested significant amounts of investor capital in participations in loans that QuarterSpot originated. DLI allegedly adopted a written valuation policy for QuarterSpot that required that QuarterSpot loans were to be valued at par, with certain exceptions for nonperforming loans. According to the complaint, from 2014 through 2017, Ross directed QuarterSpot to make payments to the funds out of QuarterSpot's operating accounts. These payments allegedly were characterized as "rebate" payments or principal payments on the loans. These payments allegedly gave investors the false impression that the underlying borrowers were making principal payments on loans that were actually delinquent. The complaint alleges that these delinquent loans should have been fully marked down pursuant to DLI's valuation policy but were not because of the fraudulent payments Ross directed. Manipulation of QuarterSpot's loan payments and performance rates allegedly led DLI to overcharge its managed funds at least $5-6 million in management and performance fees between 2014 and 2017.

The SEC's complaint charges Ross with securities fraud in violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, Section 17(a) of the Securities Act, and Sections 206(1), 206(2), and 207 of the Investment Advisers Act of 1940, as amended ("**Advisers Act**"). The complaint seeks to impose permanent injunctions, disgorgement, prejudgment interest, and civil penalties.

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

Investment Adviser Settles SEC Allegations of Unfair Trade Allocation and Related Compliance Failures

On July 31, 2020, the SEC issued an order (the "**Birinyi Order**") instituting and settling cease-and-desist proceedings against Birinyi Associates, Inc. ("**Birinyi**") for allegedly unfairly allocating trades to certain advisory clients and failing to have an adequate compliance program with respect to trade allocation.

According to the Birinyi Order, Birinyi is a registered investment adviser with approximately $288 million under management as of March 2020. Birinyi allegedly provided investment services through separate client accounts; Birinyi executed trades through a master brokerage account, and subsequently allocated those trades to its client accounts. Birinyi Associates used the master account for two primary investment strategies: (1) a day trade strategy and (2) a buy-and-hold strategy.

The SEC alleges that Birinyi would execute a block trade intended for buy-and-hold clients and monitor the price of the relevant security during the trading day. If the price increased during the trading day, Birinyi would sometimes sell the security, generating a profitable day trade, and then allocate the profitable day trade to the day trading clients, rather than holding the security for investment by the buy-and-hold clients. This practice allegedly resulted in risk-free and profitable day trades for some advisory clients at the expense of others. According to the SEC's calculations, during this time period the trades that Birinyi allocated to their day trade clients earned an average first-day return of 0.26% compared to negative 0.02% for the buy-and-hold clients. While Birinyi appears to have considered the practice fair because the buy-and-hold clients earned significantly higher average annual returns than day trading clients during the relevant time period, the SEC asserted that comparing only annual returns failed to consider that day trading clients received risk-free profits while the buy-and-hold clients were forced to bear the risks of these trades and the associated negative impact on returns.

The SEC further alleged that Birinyi failed to adopt and implement written policies and procedures designed to prevent violations of the Advisers Act relating to trade allocation. While Birinyi's compliance manual provided for a review of allocation practices, Birinyi allegedly had no policies or procedures that summarized how profitable day trades should be allocated or how the firm should achieve an equitable allocation of trades.

As a result of the conduct alleged, the SEC concluded that Birinyi violated Sections 206(2) and 206(4) of the Advisers Act and rule 206(4)-7 thereunder. Birinyi agreed to be censured, to cease and desist from further violations, to pay a civil money penalty of $100,000, to provide written notice of the Birinyi Order to its clients, and to retain an independent compliance consultant to conduct a comprehensive compliance review and assist in developing and implementing written compliance policies and procedures with respect to trade allocation, monitoring, and recordkeeping.

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

Davis Polk

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