Davis Polk

Private Equity Regulatory Update - April 2022

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In this issue, we discuss, among other things, SEC exam priorities for registered investment advisers and recent enforcement actions involving private fund advisers.

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Rules and regulations

SEC proposes new SPAC rules that are expected to significantly reduce SPAC activity

Special purpose acquisition companies (SPACs) remain in the SEC's crosshairs with this comprehensive rule proposal that expands the scope of underwriter liability, amends the scope of a safe harbor for financial projections and adopts a new safe harbor under the Investment Company Act of 1940. If adopted, the proposal would represent the most expansive regulatory consequences to SPAC business combination transactions since their creation in the early 1990s,

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and will likely chill SPAC activity. Please see Davis Polk's recent client update on this topic, which summarizes the proposed rule.

SEC proposes to require many private funds and proprietary trading vehicles to register as "dealers"

The SEC has proposed expanding what constitutes a "dealer," which could have the effect of requiring many private funds and principal trading firms to register with the SEC. Please see Davis Polk's recent client update for more information on the proposal.

Industry update

SEC Division of Examinations releases examination priorities for 2022

On March 30, 2022, the SEC Division of Examinations (Division) published its examination priorities for 2022 (Exam Priorities). The Exam Priorities fall into five categories: (1) private funds, (2) Environmental Social and Governance (ESG) Investing (3) standards of care, (4) information security and operational resiliency and (5) emerging technologies and crypto assets. For a discussion of the 2021 Exam Priorities, please see the March 30, 2021 Investment Management Regulatory Update.

Private funds

According to the Exam Priorities, the Division plans to continue to focus on SEC-registered investment advisers (RIAs) that manage private funds. Examinations will focus on the calculation and allocation of fees and expenses, the potential preferential treatment of certain investors with respect to private funds that have experienced liquidity issues, compliance with the custody rule under the Investment Advisers Act of 1940, as amended (Advisers Act), disclosure and compliance requirements for cross trades, principal transactions and distressed sales, and conflicts around liquidity (e.g., adviser-led fund restructurings). The Division will also examine risk management, investment recommendations and allocations, and portfolio strategies, with particular focus on conflicts and disclosure. The Exam Priorities noted that such exams would involve, among other things, reviews of private fund investments in SPACs, particularly where the private fund adviser is also the SPAC sponsor, as well as reviews of the practices, controls, and investor reporting with respect to risk management and trading for private funds with indicia of systemic importance, such as "outsized counterparty exposure or gross notional exposure when compared to similarly situated firms."

ESG investing

The Division will continue its focus on ESG-related advisory services and investment products (e.g., mutual funds, ETFs, private funds). Examinations will focus on: (1) accuracy of disclosures regarding ESG investing approaches, and adoption of policies and procedures with respect to such ESG-related disclosures, including review of portfolio management processes and practices; (2) compliance with proxy voting policies and procedures, and alignment of votes with ESG-related disclosures and mandates; and (3) accurate representations of the ESG factors considered or incorporated into portfolio selection in performance advertising and marketing materials.

Standards of care

The Division will continue to focus on standards of conduct issues for broker-dealers and RIAs. The examinations will focus on the satisfaction of obligations under Regulation Best Interest and Advisers Act fiduciary standards. Examinations will include assessments of practices regarding consideration of investment alternatives, management of conflicts of interest (e.g., incentives favoring certain products or strategies over others), trading (e.g., best execution), disclosures (e.g., Form ADV and Form CRS disclosures), account selection (e.g., brokerage, advisory or wrap fee accounts), and account conversions and rollovers.

The Division will focus on compliance programs, testing and training with respect to providing advice to retail investors and working families in their best interests. Focus areas for examinations of RIAs include: (1) revenue sharing arrangements; (2) recommending or holding more expensive classes of investment products when lower cost classes are available; (3) recommending wrap fee accounts without assessing whether such accounts are in the best interests of clients; and (4) recommending proprietary products resulting in additional or higher fees. Such examinations will also

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include a review of RIAs': (a) compliance policies and procedures designed to address conflicts and ensure advice provided is in the best interest of clients, including the cost of investing; and (b) disclosures to enable investors to provide informed consent.

The Exam Priorities noted that dually registered RIAs and broker-dealers continue to be an area of interest for the Division, as well as affiliated firms with financial professionals who service both brokerage customers and advisory clients. Examinations will have particular emphasis on potential conflicts of interest, including with respect to account recommendations and allocation of investments across different accounts.

Information security and operational resiliency

According to the Exam Priorities, the Division will continue to focus on information security, including, among other things, a focus on whether firms have acted appropriately to: (1) safeguard customer accounts and prevent unauthorized access to client accounts; (2) oversee vendors and service providers; (3) address malicious email activities (e.g., phishing); (4) respond to incidents, including ransomware attacks; (5) identify and detect identity theft red flags; and (6) manage operational risk related to a remote work environment. The Division will also review registrants' business continuity and disaster recovery plans, and compliance with Regulations S-P and S-ID.

Emerging technologies and crypto-assets

According to the Exam Priorities, the Division will continue to focus on technology developments. The Division will focus on firms using new emerging technologies, offering new products and services or employing new practices. Examinations will review if the operations and controls in place are consistent with disclosures made, regulatory obligations and the standard of conduct owed to investors, and account for the unique risk posed by these practices. The Division will also review advice and recommendations provided, including by algorithms, for consistency with investors' investment strategies and the standard of conduct owed to investors.

The Division will continue to identify and examine SEC-registered market participants engaged in the crypto-asset market with a focus on custody arrangements for crypto-assets, and the offer, sale, recommendation, advice and trading of crypto-assets. Examinations will review whether market participants involved with crypto-assets: "(1) have met their respective standards of conduct when recommending to or advising investors with a focus on duty of care and the initial and ongoing understanding of the products (e.g., blockchain and crypto-asset feature analysis); and (2) routinely review, update, and enhance their compliance practices (e.g., crypto-asset wallet reviews, custody practices, anti-money laundering reviews, and valuation procedures), risk disclosures, and operational resiliency practices (i.e., data integrity and business continuity plans)." The Division will also examine mutual funds and ETFs offering exposure to crypto-assets to assess, among other things, compliance, liquidity and operational controls regarding portfolio management and market risk.

Focus areas involving RIAs and investment companies

The Exam Priorities noted that the Division's examinations of RIAs typically review the RIA's marketing practices, portfolio management practices, custody and safekeeping of client assets, valuation, brokerage and execution, conflicts of interest and related disclosures. The Division will review RIAs' compliance programs for policies designed to ensure that: "(1) investment advice is in each client's best interest; (2) oversight of service providers is adequate; and (3) sufficient resources exist to perform compliance duties" and for appropriate controls regarding "the creation, receipt, and use of potentially MNPI." The Division will also review oversight practices of RIAs with heightened risks, including whether RIAs "(1) employing individuals with prior disciplinary histories implemented heightened oversight practices for these individuals; (2) migrating from the broker-dealer business model reviewed whether recommendations to transition investor accounts to advised accounts were in the clients' best interests; and (3) operating from multiple branch offices have appropriately adapted their compliance programs to oversee the activities in their branches."

Examinations of RIAs will also focus on disclosure and issues related to fees and expenses, such as: "(1) advisory fee calculation errors, including, but not limited to, failure to adjust management fees in accordance with investor agreements; (2) inaccurate calculations of tiered fees, including failure to provide breakpoints and aggregate household accounts; and (3) failures to refund prepaid fees for terminated accounts or pro-rated fees for onboarding clients."

According to the Exam Priorities, the Division will continue to prioritize examinations of registered investment companies, including mutual funds and ETFs. Examinations will review, among other things: disclosures to investors, accuracy of reporting to the SEC, compliance with the new rules and exemptive orders (e.g., ETF rules and exemptive orders for non-transparent, actively managed ETFs, and custom baskets). In reviewing liquidity risk management programs (LRMPs) of registered funds, the Division will review whether the programs are "reasonably designed to assess and manage the

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funds' liquidity risk and review the implementation of required liquidity classifications, including firms' oversight of third party service providers."

The Division will prioritize examinations of: 1) money market funds, including with respect to stress-testing, website disclosures and board oversight; and (2) business development companies, including with respect to valuation practices, marketing activities and conflicts of interest with underlying portfolio companies. According to the Exam Priorities, the Division will focus on examinations of mutual funds investing in private funds, with respect to risk disclosure and valuation issues, and will prioritize examinations of certain fund practices, such as "advisory fee waivers to assess the sustainability of services for firms that provide such waivers, and trading activities of portfolio managers that may be designed to inflate fund performance."

The Division will continue to prioritize examinations of RIAs and registered funds that have not previously been examined or have not been examined in a number of years.

AML programs

The Division will continue to focus on examining broker-dealers and investment companies for compliance with their AML obligations, including whether firms have established appropriate customer identification programs and whether they are satisfying their suspicious activity report filing obligations, conducting due diligence on customers, complying with beneficial ownership requirements and conducting robust and timely independent tests of their AML programs.

The Exam Priorities also set out focus areas for examinations involving broker-dealers, municipal advisors, security-based swap dealers, the Financial Industry Regulatory Authority (FINRA), Municipal Securities Rulemaking Board (MSRP) and market participants, such as clearing agencies and national security exchanges, and the LIBOR transition. According to the Division, the areas of focus in the Exam Priorities are not comprehensive, and they remain open to addressing emerging and exigent risks to investors and the financial markets as they arise.

– Press release

– Exam Priorities

Remarks by SEC Chair at the Penn Law Capital Markets Association Annual Conference

On April 4, 2022, SEC Chair Gary Gensler addressed the Penn Law Capital Markets Association Annual Conference to speak about crypto markets, which have garnered swift mainstream popularity. Chair Gensler discussed three areas related to the SEC's work regarding cryptocurrency: platforms, stablecoins and crypto tokens.

Platforms: In Chair Gensler's view, "regulation both protects investors and promotes investor confidence" and is "at the core of what makes markets work." Thus, as many crypto platforms "likely are trading securities," the SEC is working on registering and regulating crypto platforms like traditional regulated exchanges so that investors are similarly protected. Further, as crypto platforms currently list both crypto commodity tokens and crypto security tokens, which include crypto tokens that are investment contracts and/or notes, the SEC is considering "how best to register and regulate platforms where the trading of securities and non-securities is intertwined." Chair Gensler noted other concerns with crypto platforms, such as the common practice of taking custody of customers' assets and acting as market makers. In response, the SEC is exploring segregating out custody and market-making functions from these platforms.

Stablecoins: Next, Chair Gensler discussed stablecoins, which he noted are usually not used for commerce, are not issued by a central government and are not legal tender. Chair Gensler noted that stablecoins raise three sets of policy issues. First, stablecoins raise considerations surrounding financial stability and monetary policy, such as questions regarding what backs these tokens so that the SEC can make sure these holdings can actually be converted into dollars. Further, as stablecoins are integral to the crypto ecosystem, the failure of a stablecoin issuer could endanger crypto trading platforms and the crypto ecosystem at large. Second, stablecoins raise concerns about their use for illicit activity. Chair Gensler noted that, as stablecoins are primarily used for crypto-to-crypto transactions, they can potentially "facilitate those seeking to sidestep a host of public policy goals connected to our traditional banking and financial system: anti-money laundering, tax compliance, sanctions, and the like." Third, when investors use crypto trading and lending platforms, according to Chair Gensler, the tokens are owned by the platform and investors do not have a direct right of redemption. This creates conflicts of interest and raises questions of market integrity that would benefit from greater oversight.

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Tokens: Chair Gensler noted that a majority of crypto tokens involve a group of entrepreneurs raising money from the public in anticipation of profits, which Chair Gensler refers to as "the hallmark of an investment contract or a security." Chair Gensler emphasized the importance of registering crypto tokens that are securities with the SEC and that "any token that is a security must play by the same market integrity rulebook as other securities under our laws."

Chair Gensler concluded by reiterating that while crypto may offer new ways to raise capital and for investors to trade, "there is nothing new about people raising money to fund their projects" and investor and market protection is still necessary. Thus, in order to continue its role in protecting investors and regulating the capital markets, the SEC will continue to work to effectively regulate the new and fast-growing world of cryptocurrencies.

SEC Division of Examinations issues risk alert on observations regarding investment advisers and material nonpublic information (MNPI) compliance issues

Introduction

On April 26, 2022, the Division of Examinations (Division) issued a risk alert relating to notable deficiencies in the policies, procedures and practices of investment advisers in reviewing their access to MNPI and in monitoring certain supervised persons and their securities trading activities.

The Division noted that many advisers were failing to comply with Section 204A of the Advisers Act and Rule 204A-1 (Code of Ethics Rule). Section 204A requires advisers to implement policies and procedures reasonably designed to prevent the misuse of MNPI. The Code of Ethics Rule requires registered advisers to adopt a code of ethics that requires, among other things, certain supervised persons of the adviser to report their personal securities transactions and holdings to the adviser's chief compliance officer or other designated person.

Staff observations

The Division staff noted that the following were examples of deficiencies and weaknesses they observed.

Policies and procedures related to "alternative data." The staff noted that some advisers who used nontraditional sources to gather information on companies did not have policies to address the MNPI risks associated with the use of such alternative data providers. Specifically, the staff observed instances where there was inconsistent diligence performed on alternative data providers, no ongoing diligence assessment for such data providers after they had been engaged, or no assessment of the adviser's obligations related to the collection or provision of alternative data, even after the adviser was made aware of red flags regarding the source.

Policies and procedures related to "value-add investors." Some advisers examined by the staff did not have policies and procedures to deal with the informational risk of associating with investors who are more likely to possess MNPI, frequently known as "value-add investors." In some cases where such policies did exist, the advisers did not correctly identify and track their relationships with all value-add investors and potential sources of MNPI.

Policies and procedures related to "expert networks." The staff observed that some advisers did not have adequate policies and procedures regarding the tracking and recording of their communications with expert networks who may have access to MNPI. Other advisers did not perform sufficient levels of review of the trading activities of persons under the adviser's supervision and control in industries that the adviser had discussed with experts.

Identification of access persons. Some advisers had policies that did not adequately define access persons, and in practice, did not identify and supervise employees who should be considered access persons.

Access persons did not obtain required pre-approval for certain investments. The staff observed that some advisers did not have policies that required access persons to obtain the obligatory pre-approvals before directly or indirectly acquiring any interests in IPOs and limited offerings. As such, there were cases in which access persons purchased beneficial ownership in IPOs or limited offerings without the required pre-approvals.

Personal Securities Transactions and Holdings. The staff noted that some advisers were not reviewing the reports of access persons' personal securities transactions and holdings, not requiring the timely submission of such reports, or not requiring the contents of such reports to include the elements required by the Code of Ethics Rule. In some cases where the adviser's policies required access persons to submit reports to the adviser's chief compliance officer (CCO), they did not have policies and procedures in place to provide for the separate review of the CCO's own reporting by another

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member of adviser, effectively allowing the CCO to perform self-review on his/her own reports.

Written acknowledgment of receipt of the code. The staff noted that some access persons were not provided with a copy of the code, or did not provide written acknowledgement of receipt of the code to the adviser. In some cases, the policies of the adviser did not require the written acknowledgment of receipt of the code by access persons.

Staff observations regarding industry practices

In its Risk Alert, the Division provided the below examples of policies and practices to aid advisers in remedying the areas of concern discussed above.

Restricted list for trading investments. The staff stated that advisers should consider creating “restricted lists” of issuers about which the advisory firm has inside information, and prohibiting trading in securities of those issuers while they remain on the list.

Allocation of investment opportunities. The staff suggested implementing procedures to ensure that investment opportunities must first be offered to clients before the adviser or its employees may act upon them.

Conclusion

The staff noted that, in response to the issues identified in the deficiency letters, many advisers modified their codes of ethics and written policies, procedures, and practices to address the identified issues. The Division concluded by encouraging advisers to review their policies, procedures, and practices to ensure they are in compliance with provisions of the Advisers Act and the rules thereunder.

Litigation

SEC settles administrative charges with venture capital fund adviser for allegedly making misleading disclosures regarding management fees and commingling fund assets

On March 4, 2022, the SEC issued an order (Alumni Ventures Order or Order) instituting and settling cease-and-desist proceedings against Alumni Ventures Group, LLC (AVG), a venture capital fund adviser, and its principal, Michael Collins (Collins). AVG allegedly misleadingly described its management fees and commingled assets of its managed funds in violation of the funds’ operating agreements.

According to the Order, AVG is a venture capital fund adviser that managed $425 million in assets as of March 30, 2021. From June 2016 through February 2020, AVG allegedly described its management fee as the “industry standard ‘2 and 20.’” Although “2 and 20” is generally understood to mean an annual management fee of two percent and carried interest amounting to 20 percent of profit, AVG’s practice was to charge investors 20 percent in management fees—10 years of fees—upon an investor’s initial capital contribution. This practice was allegedly not disclosed on AVG’s website or in other marketing materials. The SEC alleges that this practice was inconsistent with what a reasonable investor would understand as an “industry standard” fee, and that Collins personally knew and approved of the use of “industry standard ‘2 and 20’” to describe AVG’s fee practices even though he was not aware of any other adviser that collected multiple years of management fees upon an initial investment.

The SEC characterized AVG’s practice of charging 10 years’ worth of fees upon an initial capital contribution as an interest-free loan from the funds AVG managed to AVG; according to the Order, the funds would have charged AVG $4,791,401 in interest had AVG paid the funds a reasonable rate of interest on this “loan.” The Order notes that AVG repaid this amount to the affected funds.

The Order also alleges that AVG commingled the assets of its managed funds through undisclosed inter-fund loans. The operating agreements of AVG’s funds stated that AVG would not commingle the assets of a fund with those of another fund, or commingle fund assets with AVG’s assets. Contrary to this representation, AVG allegedly loaned its assets to funds, or caused funds to loan assets to other funds. These loans were allegedly not documented in written debt instruments, and had no determined maturity or interest rate. The SEC alleges that these transfers violated the funds’ operating agreements, and created an undisclosed conflict of interest for AVG because AVG was solely responsible for determining the terms of both sides of each loan transaction.

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The SEC alleges that, on account of the conduct described above, AVG violated Sections 206(2) and 206(4) of the Advisers Act, and Rule 206(4)-8 thereunder, and that Collins caused AVG's violations.

AVG agreed to notify current and past investors of the settlement terms, to cease and desist from future violations, to be censured and to pay a civil money penalty of $700,000. Collins agreed to cease and desist from further violations and to pay a civil money penalty of $100,000. The Order notes that the SEC took into account AVG's remedial efforts, including adoption of policies and procedures regarding communications concerning management fees, creation of a Chief Compliance Officer position and the addition of an independent member to AVG's Board of Directors.

– AVG Order

– SEC press release regarding the AVG Order

SEC settles administrative charges with investment adviser for alleged custody rule compliance violations

On March 30, 2022, the SEC issued an order (Spruce Order or Order) instituting and settling cease-and-desist proceedings against an investment adviser, Spruce Investment Advisors, LLC (Spruce), for alleged custody rule violations and failure to adopt policies and procedures reasonably designed to prevent such violations.

According to the Spruce Order, Spruce advised approximately 100 private equity funds and, as of March 31, 2021, had approximately $182 million in assets under management. The Order states that an adviser may comply with aspects of the "custody rule" under Section 206(4) of the Advisers Act and Rule 206(4)-2 thereunder by distributing a fund's audited financial statements to investors within 120 days of the end of the fund's fiscal year. Spruce allegedly sought to rely on this alternative to comply with the custody rule, but failed to have the required audits performed or to distribute audited financial statements to fund investors for several years.

The SEC alleges that Spruce's failure to complete audited financial statements for certain funds was partially attributable to Spruce's decision, in late 2018, to reallocate to funds certain expenses that had previously been borne by a Spruce-managed fund of funds. Spruce allegedly did not consult with or apprise fund auditors of the change in allocation methodology, which allegedly caused delays in completion of the audits.

Spruce's decision to reallocate these expenses also allegedly contributed to Spruce's compliance failure. The SEC alleges that Spruce failed to adopt written policies and procedures regarding the reallocation of expenses, despite receiving a recommendation in 2016 that it do so. Relatedly, the SEC alleges that Spruce failed to adopt policies and procedures reasonably designed and implemented to avoid custody rule violations.

On account of this conduct, the SEC alleged that Spruce violated section 206(4) of the Advisers Act and Rules 206(4)-2 and 206(4)-7 thereunder. Spruce agreed to notify past and current investors of the Order, to cease and desist from future violations, to be censured and to pay a civil money penalty of $75,000.

– Spruce Order

– SEC press release regarding the Spruce Order

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