



# AIMA Private Fund Manager Training – March 3, 2021

Focus on Regulatory Trends and Compliance Practices for Private Funds and Advisers to Private Funds

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# Overview

- **Recent SEC Enforcement Actions:** Managers should study enforcement actions and review their business and fund documentation to address any actions required
- **Recent SEC Guidance:** Alerts the market as to the current requirements in examinations and enforcement
- SEC Issuing Risk Alerts
- SEC Focus on Conflicts of Interest and Fees and Expenses
- **Themes from 2020:**
  - **Transparency.** The SEC is quick to take action in cases where there is a lack of required disclosure or a conflict of interest, and in cases where an investment manager made a material misrepresentation.
  - **Policies and Procedures.** Firms need a solid infrastructure that translates policies and procedures into actions and behaviors.
  - **Holistic Approach to Compliance.** Firms must implement a risk-based approach to compliance driven by thorough due diligence of clients, employees and vendors.

# Adviser Fiduciary Duty

- Failure to have an adequate compliance program is a violation of **Advisers Act Rule 206(4)-7**, which is independent of any securities law violation
  - SEC focuses on the content of your policies in light of recent guidance and actions, and whether you abide by those policies
- Registered advisers have **fiduciary duties of care and loyalty** to their clients
  - Must act in good faith
  - Full and fair disclosure of all material facts (ADV, PPM, marketing materials)
  - Reasonable care to avoid misleading clients
  - Place client's interests ahead of adviser's interests
- Adherence to anti-fraud provisions
  - Avoid conflicts of interest

# Risk Alert: SEC Focus on COVID-19 Compliance Risks

- OCIE published a risk alert addressing certain COVID-19-related compliance risks and considerations for SEC-registered investment advisers and broker-dealers (August 2020)
- Observations and recommendations fall into six categories:
  - 1. Protection of investors' assets**
    - Firms should consider reviewing their practices, supervisory and compliance policies and procedures relating to collecting and processing investor checks and transfer requests.
  - 2. Supervision of personnel**
    - Firms should consider, for example, modifying their practices to address: oversight and interaction with supervised persons working remotely, transactions occurring outside the Firms' systems due to remote work, remote oversight of trading, etc.
  - 3. Practices relating to fees, expenses, and financial transactions**
    - Firms should consider reviewing their fees and expenses policies and procedures and consider enhancing their compliance monitoring by, for example, validating accuracy of disclosures, fee and expense calculations, evaluating risks associated with borrowing or taking loans, etc.

# Risk Alert: SEC Focus on COVID-19 Compliance Risks (cont'd)

## 4. Investment fraud

- Firms should be aware that times of crisis or uncertainty can create a heightened risk of investment fraud and should be cognizant of the risk when conducting due diligence on investments.

## 5. Business continuity

- Firms that are required to adopt and implement compliance policies and procedures that are reasonably designed to prevent violation of the federal securities laws should consider their ability to operate critical business functions during emergency events.

## 6. Protection of investor and other sensitive information

- Firms should pay particular attention to the risks regarding access to systems, investor data protection, and cybersecurity that result from the increasing shift to remote working.

# Risk Alert: Private Fund Adviser Observations

- OCIE published a risk alert to provide an overview of certain compliance issues observed in examinations of registered investment advisers that manage private equity funds or hedge funds (June 2020)
- Three general areas in which it noted deficiencies:
  - **Conflicts of Interest** (focus on private fund advisers' obligations under Section 206 of the Advisers Act and Advisers Act Rule 206(4)-8 to either cure conflicts of interest or provide full and fair disclosure of any such conflicts)
  - **Fees and expenses** (SEC generally favors full and fair disclosure and transparency of fees)
  - **Policies and procedures relating to material non-public information (MNPI)/Code of Ethics** (focus on investment advisers' obligation to maintain and enforce written policies and procedures reasonably designed to prevent the misuse of MNPI, and Advisers Act Rule 204A-1, which requires a registered investment adviser to adopt and maintain a code of ethics)

# Risk Alert: Supervision, Compliance and Multiple Branch Offices

- OCIE published a risk alert related to SEC-registered investment advisers operating out of multiple branch offices (November 2020)
- OCIE identified deficiencies in two main areas:
  - Adoption and implementation of appropriate compliance programs under the Compliance Rule in both the SEC-registered investment advisers' main offices and branch offices
  - Appropriate evaluation of the processes used by supervised persons located in branch offices to provide investment advice to advisory clients of the firm

# Risk Alert: Investment Adviser Observations – Compliance Programs

- OCIE published a list of examination observations related to notable compliance issues related to Advisers Act Rule 206(4)-7 (the “Compliance Rule”) (November 2020)
- OCIE identified deficiencies and weaknesses in connection with the Compliance Rule, which fall into six general categories:
  - Compliance resources
  - CCO authority
  - Annual review deficiencies
  - Implementing actions required by written policies and procedures
  - Maintaining accurate and complete information in policies and procedures
  - Maintaining or establishing reasonably designed written policies and procedures





# Risk Alert: Cybersecurity and Resiliency Observations

- OCIE provided a list of examination observations related to market participants' cybersecurity and operational resiliency practices (January 2020)
- Practices noted:
  - Incorporation of a governance and risk management program
  - Managing access rights and controls
  - Tools and processes addressing data loss prevention
  - Implementing security measures, establishing policies and procedures for the use of mobile devices
  - Incident response and resiliency
  - Practices and controls related to vendor management
  - Training and awareness to assess cybersecurity risks and responsibilities

# Risk Alert: Cybersecurity – Ransomware Alert

- OCIE issued a risk alert to encourage registrants to monitor the cybersecurity alerts published by the Department of Homeland Security Cybersecurity and Infrastructure Security Agency (July 2020)
- OCIE identified measures registrants are taking to monitor/guard against ransomware attacks, including:
  - Incident response and resiliency policies
  - Procedures and plans
  - Operational resiliency
  - Conducting awareness and training programs
  - Implementing vulnerability scanning and patch management programs
  - Access management through systems and procedures
  - Implementing perimeter security capabilities

# Risk Alert: Broker-Dealers and Investment Advisers: Large Trader Obligations

- OCIE published examination observations related to compliance with large trader reporting obligations under Rule 13h-1 (December 2020)
- The Rule requires:
  - persons whose transactions in national market system securities exceed daily or monthly thresholds to file Form 13H with the SEC; and
  - imposes certain recordkeeping requirements on broker dealers
- OCIE recommends that investment advisers and broker-dealers review their practices and written policies and procedures to address the requirements of the Rule



# SEC Cases

## **SEC Settles Charges Against Private Equity Fund Adviser for Insufficient Disclosure of Conflicted Expense Reimbursements (Monomoy Capital Management, L.P.)**

- On April 22, 2020, the SEC settled charges against a private equity fund adviser for allegedly violating Section 206(2) of the Advisers Act by failing to disclose a conflict of interest.
- The adviser allegedly provided fund portfolio companies with certain services through a group of the adviser's employees and billed those portfolio companies for the cost of providing the services rather than covering the costs out of its management fee.
- The SEC issued a cease-and-desist order and an order to pay disgorgement of \$1,521,972 and prejudgment interest of \$204,606, and a civil penalty of \$200,000.

# SEC Cases (cont'd)

## **SEC Settles Charges Against a Registered Investment Adviser for Misallocation of Internal Expenses (Rialto Capital Management, LLC)**

- On August 7, 2020, the SEC settled charges against an investment adviser for allegedly violating Sections 206(2) and 206(4) and Rules 206(4)-7 and 206(4)-8 of the Advisers Act.
- The SEC alleged that the adviser misallocated costs and expenses to certain funds when they should have been allocated to certain co-investment vehicles.
- The SEC further alleged that the adviser failed to adopt and implement written compliance policies and procedures reasonably designed to ensure that costs and expenses related to third party tasks were properly disclosed.
- The SEC issued a cease-and-desist order and a \$350,000 civil money penalty.

# SEC Cases (cont'd)

## **SEC Settles Charges Against Registered Investment Adviser for Ineffective Controls to Prevent Insider Trading (Cannell Capital, LLC)**

- On February 4, 2020, the SEC issued an order in which it found that an investment adviser failed to establish, maintain, and enforce policies and procedures reasonably designed to prevent the misuse of material, nonpublic information.
- The SEC stated that the investment adviser's policies and procedures were not reasonably designed to prevent misuse of material nonpublic information because they did not address any business-specific risks and lacked guidance regarding when trading in securities should be restricted.
- The SEC imposed a civil money penalty of \$150,000 against the investment adviser and issued a cease-and-desist order and a censure.
- The settlement highlights the importance of reviewing policies and procedures to examine controls and reviews of restricted lists.

# SEC Cases (cont'd)

## **SEC Charges Against Investment Advisers Failure to Disclose Financial Conflicts of Interest (Criterion Wealth Management Ins. Services, Inc., Robert Allen Gravette and Mark Andrew MacArthur)**

- On February 12, 2020, the SEC charged an investment adviser and its co-owners with failing to disclose significant financial conflicts of interest when recommending investments.
- The SEC alleged that the investment adviser breached its fiduciary duty to the seller under Sections 206(1) and 206(2) of the Advisers Act by failing to disclose that they were receiving additional compensation in connection with certain investment funds that the investment advisers recommended to their clients.
- The SEC is seeking permanent injunctions from future violations of these provisions, disgorgement and prejudgment interest, and civil penalties from the investment advisory firm and its co-owners.



# SEC Cases (cont'd)

## **SEC Charges Investment Adviser with Failure to Disclose Principal Trades (Lone Star Value Management LLC and Jeffrey Eberwein)**

- On February 24, 2020, the SEC issued an order in which it found that an investment adviser and its founder failed to disclose that they were executing principal trades.
- The investment adviser and its founder effected various trades between two funds, and because the founder's ownership interest in one of those funds was more than 35%, the trades between the funds were principal trades in violation of Section 206(3) of the Advisers Act.
- The SEC also alleged violation of Section 206(3) of the Advisers Act for failing to disclose in writing the principal trades and related conflicts of interest.
- The SEC imposed a cease-and-desist order and a civil money penalty of \$100,000 against the investment adviser and \$25,000 against its founder.



# SEC Cases (cont'd)

## **SEC Settles Charges Against Investment Adviser for Distribution of Misleading Marketing Materials (Old Ironsides Energy LLC)**

- On April 17, 2020, the SEC issued an order against a registered investment adviser for allegedly distributing misleading marketing materials.
- The SEC alleged that the investment adviser failed to implement its policies and procedures in its compliance manual concerning the use of investment performance results in marketing materials.
- The investment adviser agreed to a cease-and-desist order and further agreed to pay a \$1,000,000 civil money penalty.

# SEC Cases (cont'd)

## **SEC Settles Charges Investment Adviser for with Violating Beneficial Ownership Reporting Provisions (WCAS Management Corporation)**

- On September 17, 2020, the SEC settled charges against an investment adviser in connection with alleged violations by five private funds for failing to adhere to reporting provisions of Section 13(d) of the Exchange Act.
- The SEC alleged that the adviser caused the private funds to violate the beneficial ownership reporting provisions of Section 13(d) because, although the funds filed a Schedule 13D, they subsequently failed to file timely Schedule 13D amendments in two separate circumstances.
- The SEC issued a cease-and-desist order and a \$100,000 civil money penalty.

# SEC Cases (cont'd)

## **SEC Obtains Final Judgment Against Kik Interactive Inc. for an Unregistered Offering (Kik Interactive Inc.)**

- On October 21, 2020, obtained a final judgment against Kik Interactive Inc. (“Kik”) for allegedly conducting an illegal securities offering.
- The SEC alleged that Kik sold digital asset securities to U.S. investors without registering their offer and sale.
- The SEC issued a final judgment under which Kik is required to provide notice to the SEC before engaging in enumerated future issuances, offers, sales, and transfers of digital assets for the next three years and must pay a \$5,000,000 penalty.

# SEC Cases (cont'd)

## **SEC Settles Charges Against Investment Adviser in Connection with Inadequate Disclosures (Blue Crest Capital Management)**

- On December 8, 2020, the SEC settled charges against an investment adviser for allegedly violating Sections 17(a)(2) and (3) of the Securities Act, Sections 206(2) and 206(4) of the Advisers Act and Rules 206(4)—7 and 206(4)-8 under the Advisers Act.
- The SEC alleged that the adviser made inadequate disclosures, material misstatements, and misleading omissions concerning its transfer of top traders from its flagship client fund to a proprietary fund.
- The SEC issued a cease-and-desist order, a censure and a disgorgement and prejudgment interest of \$132,714,506 and a penalty of \$37,285,494, all which will be returned to investors.

# Speakers

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