Schulte Roth & Zabel

Private Funds Regulatory UPDATE

Compliance Roundup

August 2020

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SEC Continues to Focus on MNPI-Related Deficiencies

Notwithstanding recent media reports asserting that the number of insider trading actions brought by the Securities and Exchange Commission has dropped,[1] the SEC continues to pursue actions against investment advisers for failures to maintain robust policies and procedures on the handling of material non–public information.

[1] *See*, e.g., "Under Trump, SEC Enforcement of Insider Trading Dropped to Lowest Point in Decades," NPR, (Aug. 14, 2020), available here.

For example, on Aug. 6, 2020, the SEC filed a civil complaint[2] against the owner and principal of a registered investment adviser, alleging that he caused his advisory firm to fail to maintain and enforce policies and procedures designed to prevent and detect the misuse of material non-public information (the SEC also alleges that he personally traded on the basis of material non-public information). This case follows on the heels of two other recent settlements with investment advisers[3] charging violations of Section 204A of the Investment Advisers Act, which requires advisers — whether registered or not — to adopt policies and procedures reasonably designed to prevent the misuse of material non-public information.

In each of these matters, the SEC staff identified areas where they believed an adviser faced a heightened risk of exposure to material non-public information (e.g., firm employees holding board of directors seats, client trading in thinly-traded securities with little analyst coverage and supervised persons' contact with corporate insiders), and asserted that the firm's policies with respect to these risks were not sufficiently tailored or were not followed. This sustained enforcement focus should serve as a reminder to all private fund managers to assess whether their policies adequately address the risks associated with their business practices.

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[2] *See* Complaint, *Securities and Exchange Commission v. Jack Brewer*, Case No. 1:20-cv-06175 (S.D.N.Y. Aug. 6, 2020), available here.

[3] *See In the Matter of Cannell Capital, LLC*, Release No. IA-5441 (Feb. 4, 2020), available here and *In the Matter of Ares Management LLC*, Release No. IA-5510 (May 26, 2017), available here.

CFTC Focus on Insider Trading Continues

On Aug. 3, 2020, the Commodity Futures Trading Commission settled an enforcement action with two New York Mercantile Exchange employees (and with NYMEX itself on a vicarious liability theory) for disclosing confidential information about futures trading activity to a third-party broker. The information included the identities of counterparties to specific trades as well as the prices and other details of those trades (all of which was considered to be confidential information by NYMEX). The settlement involved a $4-million civil penalty against the three defendants and permanent injunctions and industry bars against both individuals. The defendants also agreed to cooperate in future actions relating to the underlying facts (litigation against the broker is continuing).

In 2011, the CFTC adopted Rule 180.1, explicitly modelled on SEC Rule 10b-5, which prohibits trading on material non-public information in violation of a preexisting duty, as well as trading on such information obtained through fraud or deception. Since then, the CFTC has made it a priority to identify and pursue insider trading cases. While the CFTC did not use the words "insider trading" in announcing this settlement, and while it was brought under Section 9(e)(1) of the Commodity Exchange Act and CFTC Regulation 1.59(d) (which are legacy provisions limited to abuses of an individual's position with a self-regulatory organization) — and not under Rule 180.1 — the phrase "material nonpublic information" is used throughout the consent order; this suggests that the CFTC may use this case to bolster its broader effort to uncover and prosecute insider trading in the commodities markets.

Fund managers trading commodity interests — even if they are not registered with the CFTC — should therefore ensure that their internal compliance program seeks to assess and mitigate risks related to the acquisition and use of material nonpublic information.

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Valuation Issues Continue to Be an SEC Priority

On Aug. 11, 2020, the SEC announced charges[1] against the former chief executive officer of Direct Lending Investments LLC, an investment adviser, for violating the antifraud provisions of the federal securities laws, including Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, Section 17(a) of the Securities Act of 1933, Sections 206(1), 206(2) and 207 of the Investment Advisers Act of 1940. The SEC alleged that, for approximately three years, the CEO engaged in a scheme of inflating fund returns reported to investors, and thereby enhancing Direct Lending's management and performance fees, by manipulating the payment data for certain delinquent loans (which should have been marked down under the applicable valuation policy). The CEO had instructed the loans' providers to make payments to his funds, which created a false impression that underlying borrowers were still making principal payments on the loans; this material over-valuation allegedly resulted in Direct Lending collecting over $5 million in additional fees and in the CEO receiving unwarranted compensation. The SEC complaint seeks injunctions, disgorgement, prejudgment interest and civil penalties in connection with the CEO's alleged fraudulent activities.

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[1] *See* SEC Charges Former Principal of Investment Adviser with Data Manipulation and Valuation Fraud (Aug. 11, 2020), available here.

Expense-Related Issues Continue to Trigger SEC Enforcement Actions

On Aug. 7, 2020, the SEC sanctioned Rialto Capital Management for failing to properly disclose and allocate certain costs and expenses.[1] Rialto undertook to perform, for compensation, "third party tasks" that other advisers would have caused their funds to outsource. Rialto agreed to perform these tasks at favorable rates, but the SEC alleged that Rialto (i) did not perform any analysis (after the first year) to support claims that their rates compared favorably to market rates; (ii) did not charge these expenses to its co-investment vehicles; and (iii) did not disclose that it increased an "overhead factor" over time. Therefore, in spite of having the expense charges approved by an advisory committee, Rialto's actions and omissions resulted in a settlement involving restitution of approximately $3 million, a fine of $350,000, and SEC findings that Rialto violated Sections 206(2) and 206(4) of the Investment Advisers Act and Rule 206(4)-7 and Rule 206(4)-8 thereunder. In addition, the Commission found that Rialto failed to adopt and implement written compliance policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules.

Although the settlement does not represent any new SEC initiative, it is yet another entry in an increasingly long line of actions against private fund managers for errors in (over)charging expenses to fund clients. Compliance and finance personnel at investment advisers should ensure that they budget time to review the processes and disclosures around the expense allocation process, and should expect to be questioned on their processes and determinations.

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[1] *See In the Matter of Rialto Capital Management, LLC*, Release No. 5558 (Aug. 7, 2020), available here.

CFTC Institutes Its First Anti-Money Laundering Rule Enforcement Action

On Aug. 10, 2020, a CFTC-registered futures commission merchant agreed to a settlement with the CFTC[1] resolving allegations that it violated CFTC Rule 42.2 by administering a deficient anti-money laundering compliance program and failing to detect and report suspicious (and illegal) activity. This action is relevant to private fund managers registered as commodity pool operators or commodity trading advisors because it may signal that the CFTC is taking a more aggressive enforcement approach for *any* AML-related violations within its purview.

While CPOs and CTAs are not subject to Rule 42.2 (although the CFTC has publicly warned that it may seek to impose specific anti-money laundering regulations on them[2]), they are subject to numerous AML and sanctions obligations. For example, CPOs and CTAs are:

- Liable for violations of the federal criminal money laundering statutes, including 18 U.S.C. §§ 1956 and 1957 (which make it a felony, among other things, to engage in financial transactions involving criminal proceeds in order to conceal their nature or source or to promote additional criminal acts);
- Required to comply with U.S. sanctions regulations and orders, which generally prohibit U.S. persons from engaging in transactions with sanctioned individuals and jurisdictions; and
- Subject to AML-related reporting obligations, including reporting certain transactions in excess of $10,000 and disclosing certain foreign accounts holding more than $10,000.

Finally, brokers and other counterparties often require representations about the robustness of a CPO's or CTA's AML program and sanctions compliance processes.

Given the CFTC's new AML enforcement focus, private fund managers that trade in commodity interests should confirm that they have sufficient AML policies and procedures in place. Fortunately, CPOs and CTAs that are also registered with the SEC as investment advisers may well find that they have already instituted AML programs that satisfy some or all of the CFTC's and their counterparties' expectations.

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[1] *See* CFTC Orders Interactive Brokers LLC to Pay More Than $12 Million for Anti-Money Laundering and Supervision Violations (Aug. 10, 2020) ("CFTC Release"), available here.

[2] *See* CFTC, Anti-Money Laundering (webpage), available here (providing, "In the future, it is possible that commodity pool operators (CPOs), commodity trading advisors (CTAs), swap dealers (SDs), major swap participants (MSPs) and other CFTC registrants may be required to comply with anti-money laundering regulations.").

SEC Revises Proxy Voting Guidance

As we discussed in an earlier alert,[1] on July 22, 2020, the SEC granted proxy advisory firms certain exemptions under the federal proxy rules, conditioned on — among other things — a requirement for proxy advisory firms to provide their recommendations to the subject public companies and then to provide their clients an "efficient and timely means"[2] of staying informed of any written responses received from those public companies. The SEC also revised its 2019 proxy voting guidance[3] for investment advisers to address this additional source of information on a contested proxy situation. The supplemental guidance keys in on a situation where a proxy advisory firm's electronic system "pre-populates" a client's votes and automatically submits those votes in advance of the deadline; in particular, whether that kind of arrangement satisfies an adviser's fiduciary duty in general, and in situations where there has been a public company response to the initial proxy advisory firm's recommendation.

While the SEC's goal was "to assist investment advisers in assessing how to consider the additional information that may become more readily available to them as a result of these amendments," the actual release did not provide much in the way of concrete suggestions and was more a warning to provide additional disclosures, recommending that advisers consider disclosing to clients (i) "the extent of that use and under what circumstances it uses automated voting"; and (ii) "how its policies and procedures address the use of automated voting in cases where it becomes aware before the submission deadline for proxies to be voted at the shareholder meeting that an issuer intends to file or has filed additional soliciting materials with the Commission regarding a matter to be voted upon."

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[1] "SEC Issues Final Rule Regulating Proxy Voting Advice," *SRZ Alert*, July 28, 2020, available here.

[2] *See* SEC Final Rule, Exemptions from the Proxy Rules for Proxy Voting Advice (July 22, 2020), page 104, available here.

[3] *See* SEC Guidance, Supplement to Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers (July 22, 2020), available here. The broader 2019 "Proxy Guidance" that was amended is addressed in this *SRZ Memorandum*.

Kentucky Supreme Court Dismisses Action Against Hedge Fund Managers; Case Then Revived by the Kentucky Attorney General

The Kentucky Supreme Court dismissed a $50-billion lawsuit against three hedge fund managers and their principals, holding that the plaintiffs — individual beneficiaries of Kentucky Retirement System defined-benefit plans — lacked standing.[1] The December 2017 suit alleged that the hedge fund managers breached their fiduciary duties and aided and abetted the plan trustees' breach of their duties because the plans were "severely underfunded" and that "plan mismanagement" (i.e., losses in the hedge funds managed by those three managers) was to blame, but on July 9, 2020, the court held that the individual plaintiffs — because they had received, and would continue to receive, their fixed pension benefit each month — had not suffered an injury in fact and therefore lacked standing. The Kentucky Supreme Court also rejected the plaintiffs' alternative theories of standing, which included suing derivatively on behalf of KRS and in their capacity as Kentucky taxpayers, finding that the latter was more appropriate for an action by the Kentucky Attorney General.

In response to the ruling, the Kentucky Attorney General filed an intervening complaint in the action, which acted to revive the matter.

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[1] *See Overstreet v. Mayberry*, 2019-SC-000041-TG (Ky. July 9, 2020).

CCPA Regulations Finalized and Effective

On Aug. 14, 2020, the California Attorney General announced final regulations for the California Consumer Privacy Act (which largely mirror those proposed in June 2020 and which we discussed in an earlier *Alert*) had received administrative approval and would become effective immediately. The CCPA applies to fund managers that, among other things, market to California natural person investors.

For managers that have not previously analyzed whether the CCPA applies to them, now is a good time to evaluate whether their information collection practices are subject to the CCPA (covered managers should review our June 12, 2020 *Alert*, which provides a list of key action items for fund managers). The Attorney General has also posted an FAQ for businesses.

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Applicability of the SEC's Political Contributions Rule to Contributions to the Biden-Harris Campaign

On Aug. 11, 2020, Joe Biden announced that he had selected California Senator Kamala Harris to be the Democratic Party's nominee for vice president of the United States. Given that California's public pension plans are among the largest in the country, and given that private fund managers and their personnel are subject to federal "pay-to-play" rules, many managers are considering whether there is any impact in allowing their employees to contribute to the Biden-Harris campaign.

The SEC's political contributions rule, Rule 206(4)-5, applies to contributions to "officials," defined as individuals who hold or are running for offices that have the ability to influence the hiring of investment advisers on behalf of a state or local government (or the ability to appoint individuals who do). Neither a United States Senator from California nor the vice president of the United States has such ability with respect to the California Public Employees Retirement System (CalPERS), the California State Teachers Retirement System (CalSTRS), or the University of California Retirement Plan (UC Regents). Because each such plan is managed by its respective board, the members of which do not include a United States Senator from California nor the Vice President of United States, and such offices do not have the ability to appoint members to these boards, contributions to the Biden-Harris campaign by employees of a private fund manager should not implicate the SEC's political contributions rule with respect to those three retirement plans.

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EU Privacy — EDPB Publishes FAQs on Transfers of Personal Data From the EU

Following a recent decision of the Court of Justice of the European Union (ECJ) in *Data Protection Commissioner v. Facebook Ireland Ltd and Maximillian Schrem* (known as *Schrem II*), the European Data Protection Board has published Frequently Asked Questions[1] on this decision. In *Schrem II*, ECJ examined, among other things, the validity of the so-called Standard Contractual Clauses ("SCCs") as a safe harbor for the transfers of personal data from the EU to the United States under the EU General Data Protection Regulation ("GDPR"). The decision clarifies that, while an EU controller of personal data (i.e., a person who determines the purpose and means of processing personal data) may rely on SCCs, the controller has an affirmative obligation to conduct an assessment prior to the transfer of data based on the SCCs and determine whether appropriate safeguards (including adequate protection under domestic law) can be ensured by the recipient of the data outside the EU. If the conclusion is that appropriate safeguards cannot be ensured, the EU controller must suspend or end the transfers of personal data.

The FAQs will be of interest to managers with U.K. or EU offices, or managers that receive personal data relating to U.K./EU individuals in the context of investments in European assets (e.g., consumer loan portfolios or private equity investments in U.K./EU companies).

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[1] *See* European Data Protection Board publishes FAQ document on CJEU judgment C-311/18 (*Schrems II*), available here.

Proposed Amendments to MiFID II Published

The European Commission has recently published proposals to amend MiFID II[1]. Although the proposed reforms are largely superficial, the following will be of interest to managers with offices or affiliates in the United Kingdom or European Union: (i) proposed changes to disclosure obligations with regards to costs and charges of the investment services; and (ii) proposals to carve out fixed income research and research on SME issuers from the research unbundling rules. Managers that trade commodity derivatives on EU markets will welcome the proposed measures to relax some of the aspects of the MiFID position limit rules.

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[1] *See* Proposal for a Directive of the European Parliament and of the Council (July 24, 2020), available here, and Proposal for a Commission Delegated Directive (July 24, 2020), available here.

ESMA Comments on EU Fund Platforms

ESMA has published a letter addressed to the European Commission and highlighting a number of areas in which the regulation of EU funds could be improved in the context of the ongoing review of the Alternative Investment Fund Managers Directive (known as AIFMD II). The letter is not itself a legislative proposal but is an important indicator of the direction of the policy debate surrounding the regulation of alternative investment funds and UCITS (a pan-EU retail fund product). One of the key observations in the letter relates to the need to tighten the requirements applicable to EU managers of platforms that delegate portfolio management activities to firms outside the EU. The letter urges the Commission to look at requiring such platforms to retain certain investment management and other functions, maintain sufficient resources locally, including sufficient staff (often referred to as "local substance"), as well as introducing further conditions on delegation aimed at curbing regulatory arbitrage.

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