Schulte Roth&Zabel

Private Funds Regulatory UPDATE

Compliance Roundup

May 2020

Contents:

CCO Oversight in a Remote Working Environment

While COVID-19 has changed many aspects of the working environment for private fund managers and other investment advisers, compliance and legal personnel have not been granted any dispensations from their duties by the regulators. In fact, while the SEC staff in the Office of Compliance Inspections and Examinations has stated that they understand the hardships and challenges imposed by the ongoing pandemic[1] (with similar statements being issued by the CFTC and

[1] *See* Securities and Exchange Commission, Office of Compliance Inspections and Examinations, Announcement: OCIE Statement on Operations and Exams — Health, Safety, Investor Protection and Continued Operations are our Priorities (March 23, 2020); and Securities and Exchange Commission, SEC Coronavirus (COVID-19) Response (April 9, 2020).

the National Futures Association[2]), the legal and compliance functions of private fund managers are expected, and required, to continue to operate.

Notwithstanding the regulator's empathy, both the SEC and the NFA continue to operate robust examination programs, and to institute new reviews; the SEC has also announced a new examination initiative focused on Form CRS,[3] and made it clear that the effective date for Form CRS will not be pushed back.

Given that investment advisers have largely moved to a distributed workplace setting, with some work-from-home policies being expected to continue for the foreseeable future, chief compliance officers and other compliance professionals need to be both diligent and creative in satisfying their oversight and surveillance obligations. Managers should document how their compliance programs have been adapted to address these unique circumstances and, while the full list of tasks and responsibilities that need to be addressed is quite long, should consider some of the following tools and techniques:

- *"Check-Ins" with Business Unit Heads*. Given that most advisers' personnel have lost the ability to have in–person face-to-face interactions with each other, compliance officers should be proactive in scheduling regular calls or videoconferences with investment professionals and colleagues in trading, investor relations, accounting and operations. Sustained and diverse interactions can help maintain an open environment and ensure that "Compliance" continues to receive timely information on the firm's operations. To the extent regularly scheduled calls or meetings of investment professionals are being held, compliance officers should consider participating.
- *Training*. The work-from-home model can facilitate more frequent and more targeted training sessions. With investment and administrative professionals having limited or no travel opportunities, and with a general erosion of the separation between work and non-work hours, it may be easier than ever to schedule training sessions with personnel who are difficult to reach in normal times. With the use of on-demand videoconferencing,[4] it is also possible to hold shorter, more targeted trainings with specific individuals or operational groups. As always, evidence of attendance, and copies of the materials used or the topics covered should be retained for support of this compliance effort.
- *Compliance Reminders*. Similarly, compliance officers will often circulate firm-wide or group-specific emails to explain policy updates, reinforce understanding of existing policies or address compliance matters that have come up. This process should continue, and may accelerate, and evidence of frequent outreach efforts should be retained for inclusion in a later review.

[2] *See* No-Action Positions for Commodity Pool Operators in Response to the COVID-19 Pandemic (March 20, 2020), available here; Interpretive Notice I-20-12: Coronavirus Update — NFA Branch Office Requirements (March 13, 2020), available here.

[3] *See,* generally, "SEC Form CRS: OCIE Announces Examination Focus," *SRZ Alert* (April 10, 2020) available here.

[4] *See,* generally, "Videoconferencing: Tips for Fund Managers to Navigate Security, Privacy and Compliance Risks," *SRZ Alert* (April 10, 2020) available here.

- *Review of Electronic Communications*. Many managers are finding that, in the distributed workplace, business-related electronic communications are even more pervasive. Compliance officers may want to consider additional or broader electronic communication reviews to address the increased traffic and facilitate effective surveillance. In addition, as messaging platforms, videoconferencing tools and other electronic communications applications proliferate, compliance officers should consider additional ways to detect any shift of business-related communications from archived to unarchived services.
- *Trading Reviews*. With the virtualization of the trading function, some advisers have seen an increase in trade errors and trade mismarkings. Compliance officers should be assertive in their efforts to stay in touch with the investment, operations and trading personnel to enable them to address any errors as soon as possible.

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New Custody Rule FAQs

On March 30 and April 2, 2020, the U.S. Securities and Exchange Commission's Division of Investment Management released two pieces of guidance, in the form of frequently-asked-questions, regarding issues relating to Rule 206(4)-2 ("Custody Rule") that relate to COVID-19 delays. The guidance addressed two specific challenges for advisers: surprise examination delays and unintended possession of physical certificates. Managers looking to rely on this SEC staff guidance should confirm that they satisfy the technical conditions underlying each FAQ.

Surprise Examinations. The March 30, 2020 FAQ addresses delays in receiving a "surprise audit" under the Custody Rule and it specifically states that the SEC staff would not recommend an enforcement action for a late surprise audit if the adviser reasonably believed that the independent public accountant would complete its surprise examination and file the required Form ADV-E within 120 days after the date chosen by the independent public accountant but — due to disruptions related to COVID-19 — the accountant was unable to complete; provided, however, that the accountant files its Form ADV-E no more than 45 days after the original due date.

Privately Offered Securities. The April 2, 2020 FAQ was posed on behalf of an adviser holding, on behalf of its clients, privately issued, certificated securities which could not be held by a qualified custodian because the adviser's custodian was no longer accepting physical certificates due to circumstances related to COVID-19. In the FAQ, the adviser stated that it could not identify other qualified custodians to hold these certificates and could not readily convert them into an uncertificated format to meet the privately offered securities exemption in the Custody Rule. The SEC staff indicated that it would not recommend an enforcement action so long as:

- A transfer or a change in beneficial ownership of the security can only be effected with the prior consent of the issuer or holders of the outstanding securities of the issuer;
- Ownership of the security is recorded on the books of the issuer or its transfer agent (or similar) in the name of the client;
- There is a legend restricting transfer on the certificate;
- The adviser appropriately safeguards the certificates and they can be replaced upon loss or destruction; and
- The adviser makes and keeps a record of the custodian's closure.

The new FAQ is very similar to Custody Rule guidance[5] on certificated securities that was published in 2013, but the 2013 guidance is limited to clients that are pooled investment vehicles subject to an annual financial statement audit; this FAQ removes that limitation but requires that an adviser make and keep a record of the custodian's closure. In addition, this relief is only effective while, due to

[5] Securities and Exchange Commission, Division of Investment Management, Guidance Update: Privately Offered Securities under the Investment Advisers Act Custody Rule (August 2013), available here.

COVID-19, the physical certificates cannot be held by a qualified custodian or be converted to comply with the privately offered securities exemption.

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Recent SEC Enforcement Activity

Monsoon Capital. In a recent SEC enforcement action,[6] an adviser and its principal allegedly overcharged a client fund for approximately $44,000 in travel expenses and the principal borrowed $1 million from the fund, for five days, for personal use. Both the adviser and its principal were charged with fraud and breach of fiduciary duty under Sections 206(1), 206(2) and 206(4) of the Advisers Act, and under Rule 206(4)-8. The adviser and the principal accepted cease and desist orders, the adviser was censured, and the principal accepted an industry bar. In addition, the adviser and the principal paid a $100,000 penalty.

The *Monsoon Capital* settlement is noteworthy because the — arguably — *de minimis* amount of the expense overcharge and the lack of actual harm to the fund from the loan (which was paid in full in five days) did not dissuade the SEC from imposing severe sanctions on the adviser and its principal. Legal and compliance officers should review this settlement and consider sharing it with business unit leaders as an instructive lesson on the SEC's low or zero tolerance approach to fiduciary violations and client-directed fraud.

Monomoy Capital. In another recent action, the SEC demonstrated yet again that it will not hesitate to institute enforcement actions against managers that it feels are seeking reimbursement for expenses that were not expressly agreed to by clients. In *Monomoy Capital Management, L.P.*,[7] the SEC alleged that a private equity fund manager charged its portfolio companies for the services of an in-house "Operations Group" without fully disclosing that practice or the associated conflicts of interest. The SEC brought an action for a violation of the anti-fraud provisions of Section 206(2) of the Investment Advisers Act.

Legal and compliance personnel should review the *Monomoy Capital* settlement, as it is instructive on how the SEC can deem subsequent disclosures, standing alone, to be ineffective or insufficient proxies for client consent; interestingly, the order also highlighted the fact that the firm's Form ADV (filed some time after the private equity fund's closing) did not include the expenses disclosure changes in the summary of material changes. Finally, while the settlement order expressly notes the firm's cooperation in the investigation, the sanctions still included a cease and desist order and imposed nearly $2 million in disgorgement, interest and fines.

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[6] *In the Matter of Monsoon Capital, LLC and Gautam Prakash*, Release No. IA-5490 (April 30, 2020), available here.

[7] *In the Matter of Monomoy Capital Management, L.P.*, Release No. IA-5485 (April 22, 2020), available here.

Contacts:

Brian T. Daly
Partner
Regulatory & Compliance
+1 212.756.2758
brian.daly@srz.com

Marc E. Elovitz
Partner
Regulatory & Compliance
+1 212.756.2553
marc.elovitz@srz.com

Anna Maleva-Otto
Partner
Regulatory & Compliance
+44 (0) 20 7081 8037
anna.maleva-otto@srz.com

Brad L. Caswell
Special Counsel
Regulatory & Compliance
+1 212.756.2072
brad.caswell@srz.com