Private Equity Regulatory Update

December 30, 2020

COVID-19 Update

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

Rules and Regulations

SEC Adopts Modernized Marketing Rule for Investment Advisers

In a December 22, 2020 **release** (the "**Release**"), the SEC adopted amendments (the "**Amendments**") to create a single rule that will replace the current advertising and cash solicitation rules under the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"). The Amendments relate primarily to Rule 206(4)-1 (the "**advertising rule**") and Rule 206(4)-3 (the "**solicitation rule**"), which have remained largely unchanged since their adoptions decades ago and will now be merged into a single marketing rule under Rule 206(4)-1, as amended. The Amendments have important implications for all investment advisers, including private equity and other private fund managers, particularly with respect to presentation of performance and solicitation activities. Davis Polk has issued a **client alert** and is preparing a client memorandum which will include a more detailed discussion of the Amendments.

Industry Update

OCIE Issues Risk Alert on Observations from Examinations of Investment Adviser Compliance Programs

On November 19, 2020, the SEC's Office of Compliance Inspections and Examinations ("**OCIE**") issued a risk alert to share observations from its examinations of investment adviser compliance programs. The risk alert provided an overview of compliance issues identified by OCIE related to Rule 206(4)-7 (the "**compliance rule**") under the Advisers Act. Under the compliance rule, registered investment advisers are required to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules promulgated thereunder by the investment adviser and its supervised persons. The compliance rule requires that investment advisers consider their fiduciary and regulatory obligations under the Advisers Act and that they formalize policies and procedures to address such obligations.

The compliance rule does not prescribe specific elements that investment advisers must include in their policies and procedures, and each investment adviser should adopt policies and procedures that take into consideration the nature of such investment adviser's operations. The OCIE noted that investment advisers should design policies and procedures to prevent violations from occurring and detect and remedy violations that have already occurred.

The compliance rule also requires that each investment adviser review its policies and procedures at least annually to determine their adequacy and the effectiveness of their implementation. According to the risk alert, the annual review should consider "any compliance matters that arose during the previous year, any changes in the business activities of the adviser or its affiliates, and any changes in the Advisers Act or applicable regulations that might suggest a need to revise the policies or procedures." Although the compliance rule requires only annual reviews, investment advisers should consider the need for more frequent reviews, particularly in response to significant compliance events, changes in business arrangements and regulatory developments.

The compliance rule also requires each investment adviser to designate a chief compliance officer ("**CCO**") to administer its compliance policies and procedures. The OCIE noted that an investment adviser's CCO, in addition to being competent and knowledgeable regarding the Advisers Act, should be empowered with the authority to develop and enforce policies and procedures for the investment adviser in light of its business.

The OCIE staff highlighted the deficiencies outlined below in its risk alert.

Inadequate Compliance Resources

One deficiency observed by the OCIE staff was a lack of adequate resources being devoted to investment adviser compliance programs. The risk alert highlighted the following examples:

- Some CCOs had numerous other professional responsibilities, either elsewhere within the investment adviser or with outside firms, and did not appear to devote sufficient time to fulfilling their responsibilities as CCO. While CCOs may have responsibilities in addition to their CCO role, OCIE observed cases "where such CCOs did not appear to have time to develop their knowledge of the Advisers Act or fulfill their responsibilities as CCO."

- Compliance staff at investment advisers who did not have sufficient resources in order to implement an effective compliance program. OCIE staff observed investment advisers that did not appear to devote sufficient resources to their compliance functions; for example, certain investment advisers did not provide adequate training or had insufficient staff. This lack of resources affected the implementation of the compliance policies and procedures adopted by certain investment advisers (or compliance with regulatory requirements), such as performance of annual reviews, accurate completion and filing of Form ADVs or timely responses to OCIE requests for required books and records.

- In cases where investment advisers had experienced growth in size or complexity but had not hired additional compliance staff or added adequate information technology, there were resulting failures in the implementation or tailoring of compliance policies and procedures.

Insufficient Authority of CCOs

The OCIE staff also observed CCOs "who lacked sufficient authority within the adviser to develop and enforce appropriate policies and procedures for the adviser." The risk alert highlighted the following examples:

- Some CCOs were restricted from accessing critical compliance information (e.g., trading exception reports and investment advisory agreements with key clients).
- For some investment advisers, senior management appeared to have limited interaction with their CCOs, "which led to CCOs having limited knowledge about the [investment adviser]'s leadership, strategy, transactions and business operations."
- Some CCOs were not consulted by senior management or employees of the investment adviser regarding matters with potential compliance implications.

Annual Review Deficiencies

The OCIE observed investment advisers that were "unable to demonstrate that they had performed an annual review or whose annual reviews failed to identify significant existing compliance or regulatory problems." The risk alert highlighted the following examples:

- *Evidence of annual review*. Certain investment advisers claimed to engage in ongoing or annual compliance reviews of their policies and procedures to determine the adequacy of such policies and procedures (as well as the effectiveness of their implementation), but could not provide evidence that such a review occurred.
- *Identification of risks*. Certain investment advisers claimed to have performed limited annual reviews but had failed to identify or review key risk areas applicable to the investment adviser, such as conflicts of interest and protection of client assets.
- *Review of significant aspects of adviser's business*. Certain investment advisers failed to review significant areas of their business, such as policies and procedures surrounding the oversight and review of recommended third-party managers, cybersecurity and the calculation of fees and allocation of expenses.

Implementing Actions Required by Written Policies and Procedures

The OCIE also observed investment advisers that did not implement or perform actions required by their written policies and procedures. The risk alert noted that certain investment advisers failed to:

- train their employees;
- implement compliance procedures regarding trade errors, advertising, best execution, conflicts of interest, disclosure and other requirements;
- review advertising materials;
- follow compliance checklists and other processes, including back-testing fee calculations and testing business continuity plans; and/or
- review client accounts (e.g., in order to determine consistency of portfolios with a client's objectives)

Maintaining Accurate and Complete Information in Policies and Procedures

OCIE observed investment advisers' policies and procedures that contained outdated or inaccurate information about the investment adviser, including generic policies that contained unrelated or incomplete information.

Maintaining or Establishing Reasonably Designed Written Policies and Procedures

The OCIE observed investment advisers that did not maintain written policies and procedures or that otherwise failed to establish, implement or appropriately tailor written policies and procedures reasonably designed to prevent Advisers Act violations. For example, the OCIE observed investment advisers that claimed to rely on informal processes rather than maintaining written policies and procedures as required. In addition, the OCIE observed investment advisers that utilized policies of an affiliate—such as a broker-dealer—which were not tailored to the specific business of the investment adviser.

According to the risk alert, in cases where firms did maintain written policies and procedures, OCIE staff observed deficiencies or weaknesses in the following areas:

- *Portfolio management*
  - Due diligence and oversight of outside managers
  - Monitoring compliance with client investment and tax planning strategies
  - Oversight of third-party service providers
  - Due diligence and oversight of investments, including alternative assets
  - Oversight of branch offices and investment advisory representatives to ensure they were in compliance with the adviser's policies and procedures
  - Compliance with regulatory and client investment restrictions
  - Adherence with investment advisory agreements
- *Marketing*
  - Oversight of solicitation arrangements;
  - Prevention of the use of misleading marketing presentations, including on websites; and
  - Oversight of the use and accuracy of performance advertising
- *Trading Practices*
  - Allocation of soft dollars
  - Best execution
  - Trade errors
  - Restricted securities
- *Disclosures*
  - Accuracy of Form ADV
  - Accuracy of client communications
- *Advisory fees and valuation*
  - Fee billing processes, including how fees are calculated, tested or monitored for accuracy
  - Expense reimbursement policies and procedures
  - Valuation of advisory client assets
- *Safeguards for client privacy*
  - Regulation S-P
  - Regulation S-ID

  - Physical security of client information
  - Electronic security of client information, including encryption policies
  - General cybersecurity, including access rights and controls, data loss prevention, penetration testing and/or vulnerability scans, vendor management, employee training or incident response plans

- *Required books and records*: Deficiencies related to written policies and procedures to make and keep accurate books and records as required under Rule 204-2 under the Advisers Act
- *Safeguarding of client assets*: Deficiencies related to policies and procedures regarding custody and safety of client assets
- *Business continuity plans*: Deficiencies regarding the maintenance of adequate disaster recovery plans (e.g., because the business continuity plans were not tested or did not contain contact information or designate responsibility for business continuity plan actions)

Conclusion

In the risk alert, the OCIE encouraged firms to review their written policies and procedures—including implementation of such policies and procedures—to ensure that they are tailored to an investment adviser's business and adequately reviewed and implemented.

- **See a copy of the Risk Alert**

Staff Statement on Wyoming Division of Banking's "NAL on Custody of Digital Assets and Qualified Custodian Status"

On November 9, 2020, the staff of the SEC Division of Investment Management issued a statement regarding a recent letter by the Wyoming Division of Banking which included views relating to the definitions of "bank" and "qualified custodian" under the Advisers Act and Rule 206(4)-2 thereunder (the "**Custody Rule**").

The Letter

In the letter, the Wyoming Division of Banking sought to address questions surrounding the custody of digital assets and ultimately concluded that the requesting Wyoming-chartered public trust company (the "**Trust Company**") was permitted to provide custodial services for digital and traditional assets under Wyoming law. The Wyoming Division of Banking also concluded that the Trust Company served as a "qualified custodian" under the Custody Rule, and stated that it would not recommend enforcement action to the SEC under these circumstances.

The Wyoming Division of Banking's letter expressly stated that its views "should not be construed to represent the views of the SEC or any other regulatory agency." The SEC staff issued its Statement to encourage parties to connect directly with SEC staff regarding the application of the Custody Rule to digital assets, including with respect to the definition of "qualified custodian." The SEC staff noted that the determination of who qualifies as a "qualified custodian" is complicated, as it is heavily based on specific facts and circumstances.

Request for Feedback

In the Statement, the SEC staff requested feedback on the following topics relating to "qualified custodians":

- "Do state chartered trust companies possess characteristics similar to those of the types of financial institutions the Commission identified as qualified custodians? If yes, to what extent?

- In what ways are custodial services that are provided by state chartered trust companies equivalent to those provided by banks, broker-dealers, and futures commission merchants? In what ways do they differ? Would there be any gaps in - or enhancements to - protection of advisory client assets as a result of a state chartered trust company serving as qualified custodian of digital assets or other types of client assets?
- How do advisers assess whether an entity offering custodial services satisfies the definition of qualified custodian in the Custody Rule? What qualities does an adviser seek when entrusting a client's assets to a particular custodian? Do the qualities vary by asset class? That is, are there qualities that would be important for safeguarding digital assets that might not be important for safeguarding other types of assets? If so, what qualities and why? Should the rule prescribe different qualities based on asset class, or should the rule take a more principles-based approach and allow advisers to exercise care in selecting a custodian?
- Are there entities that currently satisfy the definition of qualified custodian under the Custody Rule that should not be included within that definition because they do not meet the policy goals of the rule? If so, which ones and why? Conversely, are there entities that currently do not satisfy the definition of qualified custodian but should? If so, which ones and why?"

The Statement noted that submissions will be made public and requested that submissions be emailed to: **IMOCC@sec.gov**, with "*Custody Rule and Digital Assets*" included in the subject line.

- **See a copy of the statement**

Litigation

Five Advisory Firms and Broker-Dealers Settle SEC Charges Relating to Improper Sales of Exchange-Traded Products

On November 13, 2020, the SEC announced that it had settled actions against three investment advisory firms and two dually registered broker-dealer and advisory firms related to allegedly improper sales of volatility-linked exchange-traded products. The actions were filed against American Portfolios Financial Services/American Portfolios Advisors Inc. ("**American Portfolios**"), Benjamin F. Edwards & Company Inc. ("**Benjamin Edwards**"), Royal Alliance Associates Inc. ("**Royal Alliance**"), Securities America Advisors Inc. ("**Securities America**"), and Summit Financial Group Inc. ("**Summit Financial**") for their involvement in sales of products that attempted to track short-term volatility expectations in the market.

According to the SEC, representatives of the five firms recommended that clients buy and hold certain volatility-linked exchange-traded notes that offered exposure to futures contracts on the CBOE volatility index (the "**VIX**"). The advisers allegedly made this recommendation even though the offering documents for those products made it clear that they were intended for short-term holding and were likely to experience a decline in value when held over a longer period. The prospectuses for the exchange-traded notes warned that the value of the futures contracts would likely decrease over a long-term period and that the potential upside of investment in the exchange-traded notes would be correspondingly limited. Nevertheless, representatives of the firms recommended that their customers and clients buy and hold the products for longer periods—including, in some circumstances—for months and years.

The SEC further found that each firm failed to adopt written policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules regarding the suitability of recommending investments in volatility-linked exchange-traded products for retail advisory clients. Additionally, the SEC Orders against American Portfolios and Benjamin Edwards found that those firms failed to reasonably supervise certain brokerage representatives who recommended that their customers buy and hold volatility-linked products in violation of federal securities laws.

As set out in all five Orders, the firms violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder. Additionally, as set out in the two Orders for American Portfolios and Benjamin Edwards, the SEC found that the firms violated Section 15(b)(4)(E) of the Securities Exchange Act of 1934 for failing to reasonably supervise their respective registered representatives in an effort to prevent violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933.

To settle charges, each firm agreed to pay civil money penalties. American Portfolios and Benjamin Edwards will pay $650,000 each, Securities American and Summit Financial will pay $600,000 each, and Royal Alliance will pay $500,000. Additionally, each firm agreed to (i) a censure, (ii) pay disgorgement and prejudgment interest, and (iii) cease and desist from future violations.

- **See a copy of the Press Release**
- **See a copy of the SEC Order – American Portfolios Financial Services and American Portfolio Advisors, Inc.**
- **See a copy of the SEC Order – Benjamin F. Edwards & Company**
- **See a copy of the SEC Order – Summit Financial Group**
- **See a copy of the SEC Order – Securities America Advisors**
- **See a copy of the SEC Order – Royal Alliance Associates**

SEC Settles with Investment Advisers for Alleged Disclosure Failures Relating to Transfer of "Top Traders" to Proprietary Hedge Fund

On December 8, 2020, the SEC issued an order (the "**BlueCrest Order**") instituting and settling cease-and-desist proceedings against BlueCrest Capital Management Limited ("**BlueCrest**"), a previously registered investment advisor, for BlueCrest's allegedly inadequate disclosures, misstatements, and omissions relating to the transfer of "top traders" from management of a client fund, BlueCrest Capital International ("**BCI**"), to a proprietary fund, BSMA Limited ("**BSMA**"). The $170 million of disgorgement and penalties imposed on BlueCrest underscores the SEC's continued focus on alleged investor injury flowing from conflicts of interest between a fund and its managers, and on the adequate, accurate, and advance disclosure of actual or potential conflicts of interest.

According to the Order, from October 2011 through December 2015 (the "**Relevant Period**"), BlueCrest managed a "flagship" client fund, BCI, and a proprietary fund, BSMA. BSMA was 93 percent owned by members of the Executive Committee of BlueCrest. BCI's investors, according to the SEC, included pension funds for American retirees. BlueCrest's primary capital allocations were to rates and relative value ("**Rates and RV**") trading strategies.

The SEC alleges that in 2011, BlueCrest decided to form a proprietary fund to "assist in attracting and retaining the employment of traders and other senior managers." Over the relevant period, BlueCrest allegedly transferred almost half (around 48 percent) of its highest-performing Rates and RV traders—who had been trading for BCI—to BSMA, hired new traders who were eligible to trade for either fund to trade solely for BSMA, and according to communications during this period, "failed adequately to consider the effects on BCI of their allocation of high-performing traders to BSMA, and focused instead on the positive benefits to BSMA."

The BlueCrest order also notes that BlueCrest replaced the capital allocations of the traders transferred to BSMA by allocating a substantial amount of BCI capital to a new semi-systematic, algorithmic trading system—Rates Management Trading ("**RMT**")—which was used to "track[] some of the trading activity of a subset of BlueCrest's live Rates and RV traders but generally underperformed those traders." According to the Order, from 2012 through 2015, BCI's capital allocations to RMT ranged from approximately $1.87 billion to $7.89 billion, which represented 17 percent to 52 percent of BCI's total allocated capital. Without RMT, the SEC found it unlikely that BlueCrest would have been able to move as many traders in such a short time period while maintaining BCI's overall level of allocated capital. The SEC alleges that RMT also created a conflict of interest because BlueCrest could retain a greater percentage of performance fees generated by RMT than they could with performance fees generated by Rates and RV traders. In addition, throughout this relevant time period, BlueCrest continued to increase the capital allocation to RMT in BCI, despite internal reports reflecting that RMT generally performed worse than BlueCrest's live Rates and RV traders.

The SEC alleges that BlueCrest faced a "conflict of interest in managing a proprietary fund, BSMA, whose primary trading strategies overlapped with those of BCI," and that the conflict of interest was exacerbated by the fact that the Executive Committee of BlueCrest had a larger ownership interest in BSMA than in BCI.

According to the SEC, BlueCrest failed adequately to disclose, and made misstatements and omissions to BCI investors and/or prospective investors concerning BSMA's existence, the movement of traders, RMT, and related conflicts of interest. According to the Order, investors would regularly request information on all of BlueCrest's funds—including all of its proprietary funds, BCI's traders, and BlueCrest's conflicts of interest—but while BlueCrest disclosed the existence of other proprietary funds and touted its live traders in BCI, it never mentioned BSMA's existence, trader movements, RMT, and related specific conflicts of interest, to prospective and existing investors. Moreover, BCI's independent directors, who also sat on the BSMA board, received inadequate disclosure concerning certain material facts about RMT as well. For example, in July 2012, BlueCrest told BCI's independent directors that RMT was a "project" that was "in the early stages of development," when in fact, BlueCrest had been using RMT in BCI since January 2012. Similarly, according to the Order, BlueCrest failed to inform independent directors about its conflict of interest in deploying RMT, or the fact that RMT underperformed the live traders whom it tracked.

Based on the conduct described above, the SEC alleged that BlueCrest violated Sections 17(a)(2) and 17(a)(3) of the Securities Act and Sections 206(2) and 206(4) of the Advisers Act and Rules 206(4)-7 and 206(4)-8 thereunder. The SEC ordered BlueCrest to cease and desist from any further violations and ordered BlueCrest to pay disgorgement in the amount of $107,560,200, prejudgment interest in the amount of $25,154,306, and a civil penalty in the amount of $37,285,494 to the SEC. In addition, in anticipation of the institution of these proceedings, the Respondents have submitted Offers of Settlement, which the Commission has determined to accept.

- **See a copy of the BlueCrest Capital Management Limited Order**
- **See a copy of the SEC Press Release**

Davis Polk

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