2021 EXAMINATION AND ENFORCEMENT PRIORITIES FOR ASSET MANAGERS

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ROPES & GRAY
April 13, 2021

AGENDA

- **SEC Exam Trends, Gensler Impact, Key Conflict and Novel MNPI Issues**
- Enforcement Priorities for Antitrust Enforcers
- Technology Driven Examination Priorities
- ESG Focus

New Approach to Exams

- While there was a pause at the start of the shutdown, the pace has continued to swing upward since July 2020
  - Diminished focus on ‘broken windows’
  - Staff has shown increased transparency, desire to get to the heart of the matter more quickly
  - Non-traditional information gathering including interrogatory-based requests and proactive outreach to third parties (e.g., auditors, intermediaries)
  - Increased number of interviews during exams
- New trend involving limited “check-in” exams within 1-2 years of a prior “problem” exams, to confirm that advisers have delivered on any undertakings or remedial measures

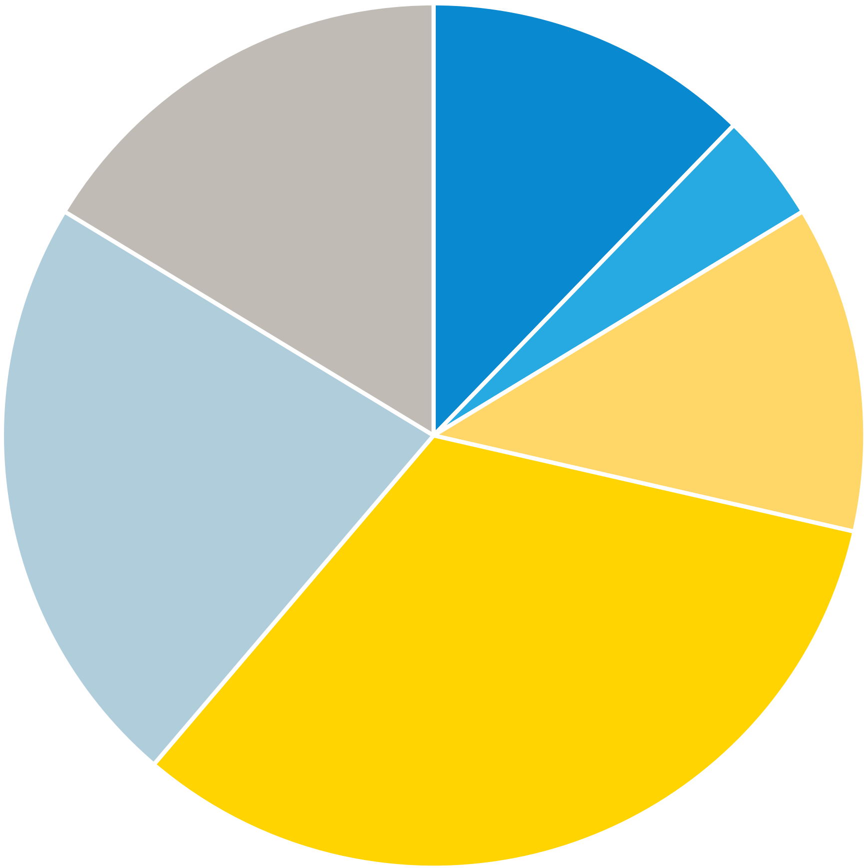
Recurring Initial Exam Requests

Documentation for approvals in trades on restricted lists
Changes in valuation methodologies, asset impairments or write-downs/write-offs
Business continuity plans and pandemic-specific policies
Risk matrices, list of changes to compliance policies
ESG-related requests
Optional “First Day Deck” (no longer always an explicit request)
Compliance consultant reports and engagement letters
Violation logs
Procedures for overseeing remote employees, including cyber-security controls
Desktop procedures (in addition to compliance policies and procedures)
Employee investment vehicles (same information as provided with respect to clients/funds)
Access person trade blotters
Other business activities of employees
Employee emails on key topics, although the request is still relatively rare

Adviser Deficiency Letter Trends

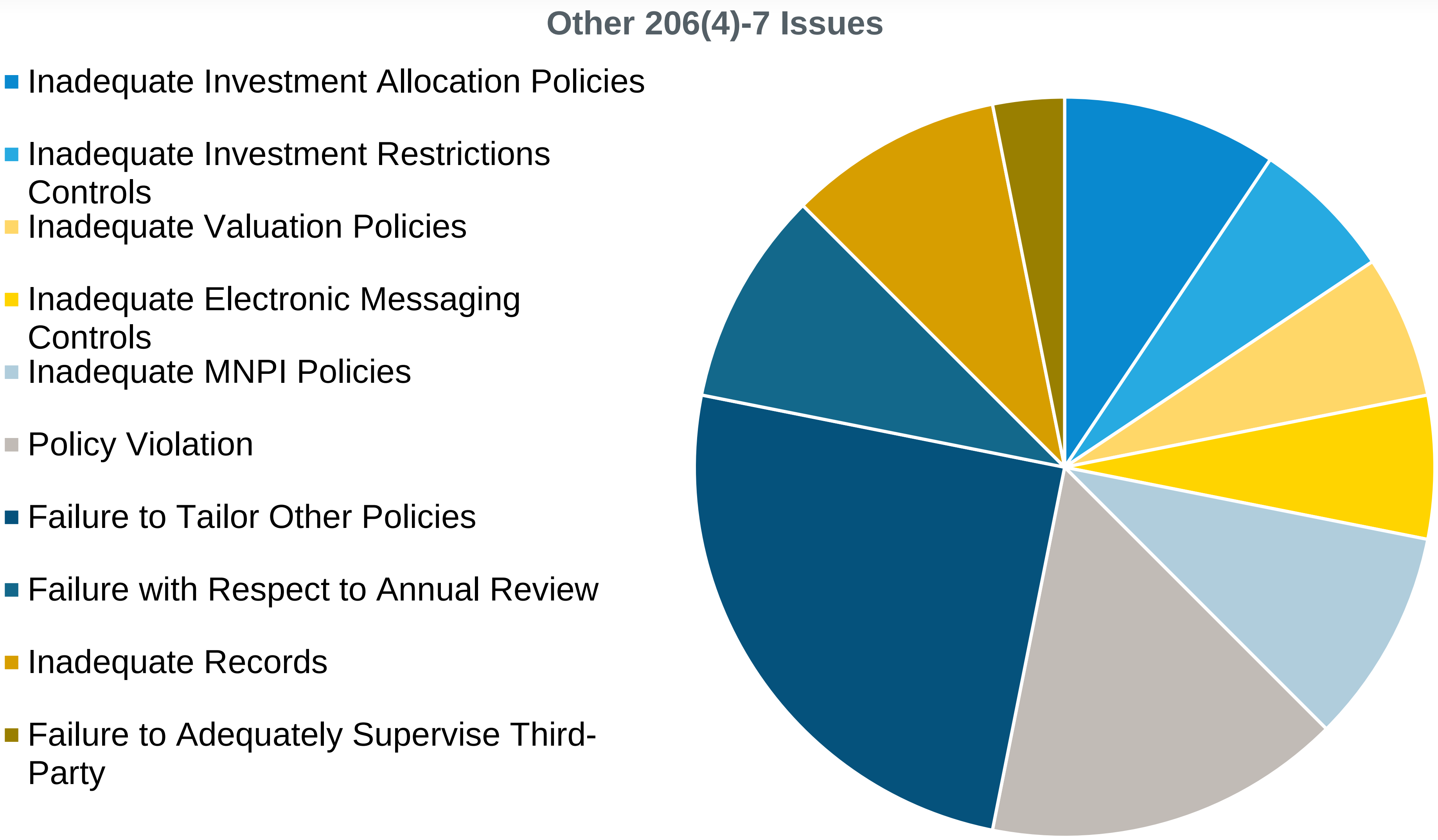
Fee and Expense Deficiencies

- Allocation of Internal Employee Time
- Allocation of Non-Employee Overhead (e.g. Rent)
- Undisclosed Fee/Expense
- Improper Allocation (e.g., Third-Party Expenses)
- Calculation Concern (e.g., Management Fee)
- Other



* From Deficiency Letters received 2017-present.

Adviser Deficiency Letter Trends



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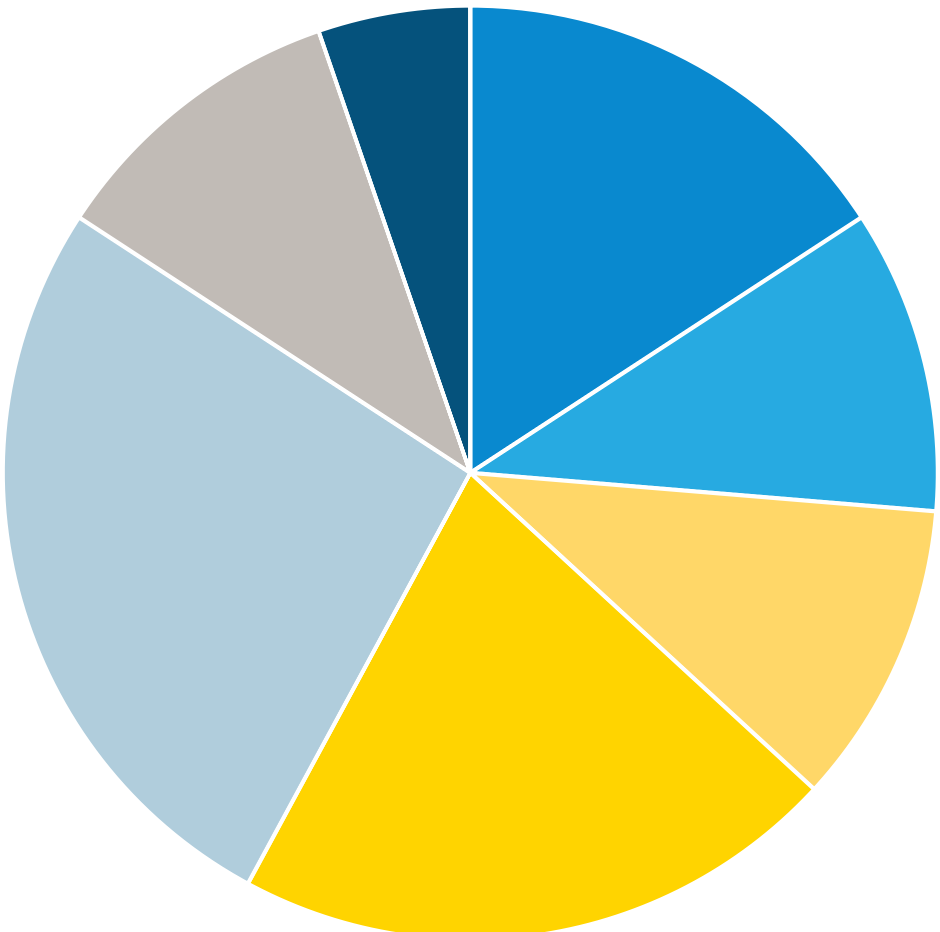
Adviser Deficiency Letter Trends

Other 206(4)-8 Issues

- Misleading Investment Allocation Disclosures
- Failure to Disclose Valuation Practices
- Misleading Performance Disclosures
- Other Misleading Marketing Disclosures
- Other Conflict of Interest
- Failure to Meet Other Affirmative Representations
- Cyber/Privacy Controls



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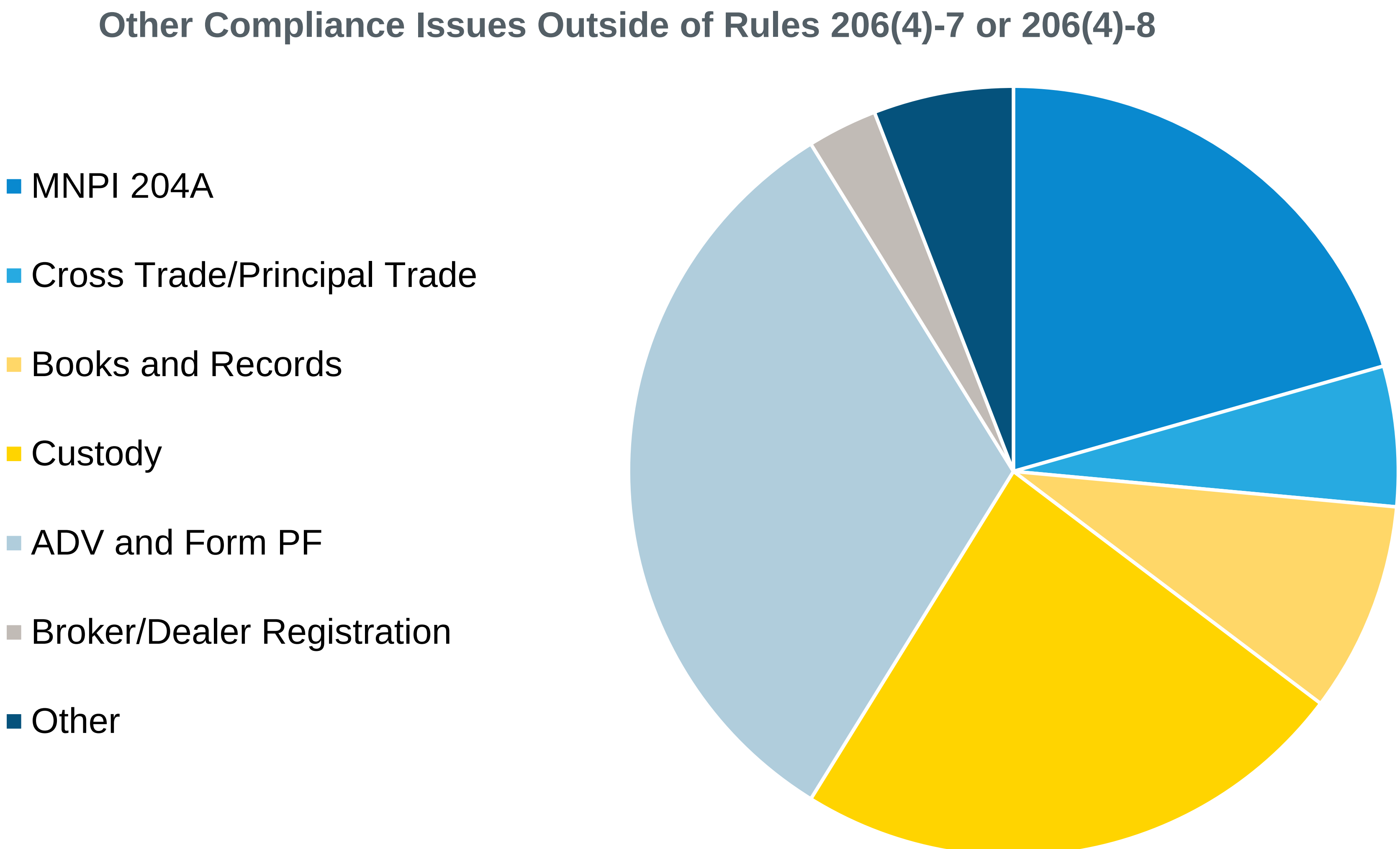
Adviser Deficiency Letter Trends



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Chair Gensler

- Likely Priorities for Gensler as SEC Chairman
  - Rulemaking that promotes increased diversity in corporate governance. Gensler proposed a rule on this topic while he was with the CFTC, but it failed to win approval
  - Increased enforcement actions on insider trading violations
  - Increased enforcement actions against companies “impeding” whistleblowers
  - Clarity for investment firms and broker-dealers on what constitutes environmental, social, and governance (ESG) investments, along with rulemaking on how to demonstrate those investments meet the standard.
  - New rules for public companies on how to disclose the risks posed to their businesses by climate change
  - A focus on cryptocurrency, along with a strong focus on investor protection and regulations of the market

Gensler on Cryptocurrencies

- Gensler's views on cryptocurrency have taken center stage since his nomination was announced
  - *Knowledgeable*—having taught a course on Cryptocurrencies and Blockchain at MIT's Sloan School of Management
  - *Supportive*—Gensler has written that he believes that crypto technology can be a "catalyst for change"
  - *Nuanced*—Gensler does not believe that all virtual currencies should be treated alike and has distinguished Bitcoin from other digital assets

  What we expect:
  - Measures that bring cryptocurrencies within the SEC's regulatory framework
  - An emphasis on investor protection

Insider Trading – Special SPAC Considerations

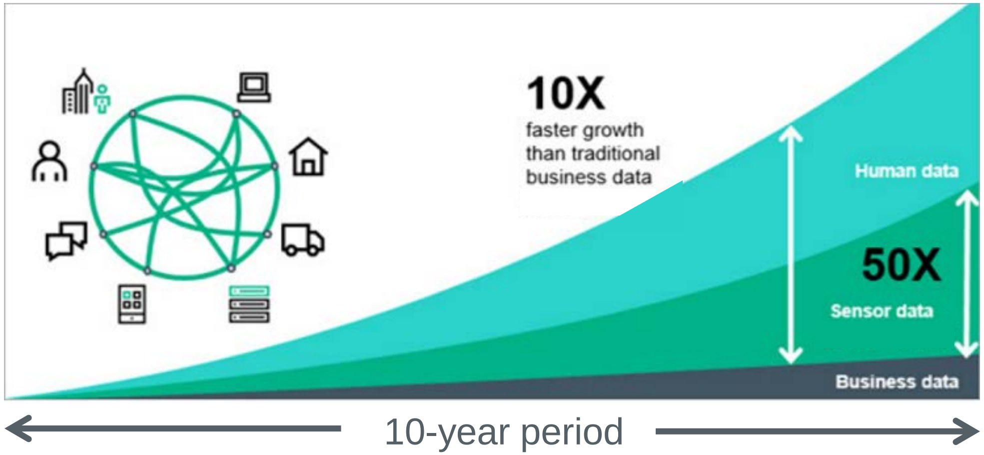
SPACs give rise to a host of potential insider trading issues.

The following are types of information that a regulator may consider to be MNPI:

- The identity of potential targets
- Finances of a target
- Timing of an Initial Business Combination
- Cash needs of the SPAC
- Excessive Redemptions
- Success of pre-combination financing, including the success of any PIPE offering.
- Any information learned in the PIPE process.

Insider Trading – Alt. Data Considerations

- Data Growth Expected to Continue to Accelerate
- The majority of this growth is expected to be in alternative data, posing potential Data and Securities Regulation Risks



Source: insidebigdata.com

Insider Trading / Outsider Trading

- Section 10(b) insider trading cases have historically relied on “classical” or “misappropriation” theories
  - Both theories require the government to prove a breach of a duty between the violator and the source of the information
- Outsider Trading
  - No duty is owed to the source of the information; liability instead stems from the possession of material non-public information by some other unfair, illegal or unauthorized means
  - Potential liability from scraped data if the information was obtained through fraudulent misrepresentation
    - Agreeing to terms and conditions that prohibit data scraping
    - Cycling through IP addresses to evade website blocking

Post COVID Valuation Focus

Common focus of enforcement issues related to policies and procedures:

- Undisclosed changes in methodology (for the same investment, among different investments)
- Review and testing of valuations, including back-testing after sales to confirm reasonableness
- Failure to maximize observable inputs, or failure to impair
- Consistency with valuation procedures
- Use of independent third-party pricing vendors without controls to ensure actual independence or prevent manipulation, or discretionary use of third-party pricing vendors without sufficient conflicts controls
- Documentation in support of model inputs and assumptions, GAAP compliance
- Departures from model outputs

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Current (And Future) State of Antitrust

- **Activism and Enforcement Not Seen since the 1970s**
  - Bipartisan support for more funding for FTC and DOJ for antitrust enforcement
  - Proposed amendments to HSR could increase number of transactions subject to filing requirements
  - Potential for significant shift in antitrust policy and progressive legislation
- **High-technology firms (particularly in consumer facing segments)**, digital platforms and "industry disruptors" among the most likely to be in the antitrust cross-hairs
- **DOJ Antitrust Division "leaning in"** and identified Financial Services and FinTech as enforcement priority area – expected to continue
- **Areas of expected enforcement:**
  - M&A in Financial Services and FinTech
  - Civil and Criminal Conduct
  - Digital Assets and Blockchain Technology

FinTech M&A

- **DOJ Antitrust Division Restructuring**
  - Consolidated expertise in new "Financial Services, Fintech, and Banking Section"
- **Increased FinTech M&A Enforcement in 2020**
  - *Intuit/Credit Karma*
  - *Visa/Plaid*
    - Signals DOJ's willingness to challenge acquisitions even when target is not actually competing with the acquirer
- **Expected M&A Enforcement Activity**
- **What Clients Need to Plan for:**
  - Exercise appropriate antitrust diligence in evaluating greater risks across deals;
  - HOHW clauses become far riskier for any strategic acquirer given antitrust agency willingness to bring challenges;
  - Likely to see increased use of RTFs; and
  - Lengthier review and time to close.

Civil and Criminal Conduct Enforcement

<u>Civil</u>

- **DOJ Civil Conduct Task Force**
  - Newly formed DOJ Civil Conduct Task Force in conjunction with Financial Services, FinTech and Banking Section increases risk civil conduct will be scrutinized
  - ***E.g.*, Visa Debit-Card Practices.** Recently disclosed investigation focuses on whether Visa's actions allow it to unlawfully maintain a dominant market share

<u>Criminal</u>

- **DOJ Antitrust and SEC have worked closely to prosecute antitrust violations in the financial markets**
  - *FX Investigation*
  - *LIBOR Rate Manipulation Investigation*
  - *Muni Bonds Investigation*
- **DOJ Antitrust and SEC entered into Memorandum of Understanding in 2020**
  - Solidifies and institutionalizes close cooperation between the agencies
  - Establishes regular means of communication between the agencies

Digital Assets and Blockchain Technology

- **Antitrust Agencies Focused on Understanding Digital Assets and Blockchain's Impact on Competition**
  - DOJ Antitrust Division training lawyers and economists on blockchain, AI and machine learning and joined Computational Antitrust Project hosted by Stanford University
  - FTC created 'Blockchain Working Group'
- **DOJ recognizes benefits, but potential for anticompetitive behavior on financial services sector using blockchain technology**
  - Sharing sensitive pricing or cost detail with competitor on blockchains may lead to price fixing
  - Automatic execution of "smart contracts" in a blockchain may also facilitate anticompetitive agreements
  - Blockchain consortia and anticompetitive behavior
- **No DOJ or FTC antitrust actions yet involving blockchain**, but DOJ has prosecuted use of algorithmic pricing tools to facilitate price fixing conspiracy

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Technology Driven Examination Priorities

- **Alternative Data / Data Sourcing**
- **Supply Chain Cybersecurity (*SolarWinds)***
- **“Resilience”: DR, Continuity, Reliability**
- **Tech in Digital Assets**
- **FinTech/RegTech Management**
- **On the horizon: *Data Driven Risk Analysis***
- **Sources—how to stay current**

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SEC Focus on ESG – Recent Updates

- The SEC has enhanced focus on ESG, and new rulemaking initiatives are likely

February 24	February 26:	March 11	March 15	March 17	March 19	March 22
Acting Chair Lee directs Division of Corporate Finance to review public company ESG Disclosures	Office of Investor Education and Advocacy publishes bulletin on ESG mutual funds and ETFs	Acting Director of Division of Corporate Finance advocates for development of public-company ESG reporting rules	Acting Chair Lee encourages ESG disclosures, and invites public comment including the potential for private-company ESG reporting	Acting Chair Lee encourages revising proxy voting guidance to encourage greater ESG engagement	AMAC ESG Subcommittee hosts panel discussion on preliminary proposal to require mandatory public company ESG reporting	SEC publishes web page consolidating information concerning ESG initiatives across its Divisions

- Meanwhile established anti-fraud and fiduciary principles will guide EXAMS and Enforcement, as the Divisions seek to bring clarity to the definitions used in ESG investing, and ensure accountability among market participants

March 3: Division of Examinations

Division of Examinations announces 2021 priorities, which include an enhanced focus on climate and ESG-related risks, including as they relate to business continuity plans, and an express focus on whether advisers' disclosures regarding ESG strategies are supported by policies and procedures to ensure conduct aligns with investor expectations

March 4: Division of Enforcement

SEC Announces ESG Enforcement Task Force of twenty-two members charged with evaluating public company and advisers' and funds' ESG disclosures under existing anti-fraud rules, utilizing advanced data analysis method

April 9: Division of Examinations

Division of Examinations issues Risk Alert on ESG investing with observations from recent exams highlighting areas of potentially misleading statements regarding ESG investing and other potential deficiencies, plus observations regarding effective practices

SEC ESG Risk Alert

- Exams will focus on:
  - Portfolio Management
  - Performance Advertising and Marketing
  - Compliance Programs
- Deficiencies and internal control weaknesses observed by the staff
  - Portfolio management practices were inconsistent with disclosures about ESG approaches
  - Controls were inadequate to maintain, monitor, and update clients' ESG-related investing guidelines, mandates, and restrictions
  - Proxy voting may have been inconsistent with advisers' stated approaches
  - Unsubstantiated or otherwise potentially misleading claims regarding ESG approaches
  - Inadequate controls to ensure that ESG-related disclosures and marketing are consistent with the firm's practices
  - Compliance programs did not adequately address relevant ESG issues

ESG – Exam Questions (General)

- Personnel involved with ESG investment operations
- ESG pitch books, one-on-one presentations and other marketing or advertising materials, including related website or blog postings
- All responses to RFPs and DDQs for ESG investment services/products
- Names of all consultants, placement agents, etc. used to solicit clients for ESG investment services/products, including compensation
- List of all accounts with ESG overlays and their strategies
- Indication of whether each advised fund is an ESG fund
- List of all investments and dates when approved as ESG investments
- ESG policies & procedures
- Web materials with respect to ESG and all investment products and services in the ESG space

ESG – Exam Questions (More Detailed)

- Internal definitions of any terms related to ESG-used disclosure or marketing
- Description of each ESG factor used (environmental, social, governance, etc.)
- Policies/procedures applying ESG factors used to determine whether an investment qualifies as an appropriate ESG investment or receives an ESG score
- If adhering to the UN Principles for Responsible Investment, provide written documentation of these principles being considered in the investment selection process (similar for other ESG protocols)
- List of ESG investments plus those previously recommended but no longer (with an explanation)
- Details about any proprietary ESG scoring system
  - Explanation of methodology
  - Factors for each score level
  - How often scores are evaluated
  - Policies/procedures for scoring
- Details about the use of third-party ESG scoring

ESG – Exam Questions (More Detailed)

- Information about ESG engagement with issuers
- Examples (up to five) of documents prepared by personnel that were material to deciding how to vote on an ESG matter or that memorialized the basis for the voting decision
- Copies of advisory contracts with parameters for ESG investments
- Most/least profitable ESG investments based on total return
- Internal analyses that quantify investment returns from ESG investments or that measure any other performance metric associated with ESG (e.g., units of reduced carbon emissions, quantifiable improvement in social or governance factors)

Fiduciary Considerations

- ESG practices must be:
  - Reconciled with Fiduciary duties (i.e. loyalty and prudence)
  - In the best interests of clients
  - Consistent with:
    - Investment strategies
    - Public disclosures
    - Advertising and anti-fraud rules
- Tension: investment results vs. social investing—compatible?
- Multitude of studies offer contradictory evidence of investment results
- ESG investing can be consistent with an adviser's fiduciary duty, but it is not automatically so:
  - Factual basis for expectations about investment policies and returns
  - Clear disclosures
  - Adherence to client mandates

Policies and Procedures

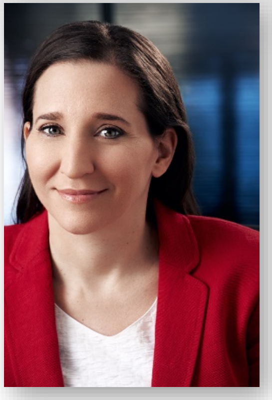
- Relevant even if accounts are not ESG-focused
  - Can communicate principles important to the firm
  - Establish or reinforce branding
- Will vary considerably depending on:
  - Client base
  - ESG focus
  - Jurisdictions and laws involved
  - Geographic and industry concentrations
- Typically:
  - Incorporate compliance measurements
  - Are part of Rule 206(4)-7 policies and procedures
  - Seek consistency with proxy voting policies and procedures
  - Identify “ownership” across or for the firm (business units, committee, etc.)
  - Articulate whether (and if not, why not) the firm uses 3rd parties to pursue ESG-related considerations
- CCO challenge: How to measure and test

Presentation Materials and CLE Credit

- **Presentation Materials**
  - Slides from today's presentation, accompanying reference materials, and a recording of today's webinar will be circulated via email
  - Materials will also be posted on the 'Events & Webinars' page of the Ropes & Gray website
  - Contact information for today's speakers is included on the next slide

- **CLE Credit**
  - CLE credit is available for this program
  - In order to receive credit, please complete the affirmation form (to be distributed via email following the conclusion of this program), including the CLE code that was read during the webinar
  - Completed forms and/or questions regarding CLE credit should be submitted to CLE.Team@ropesgray.com

Thank You



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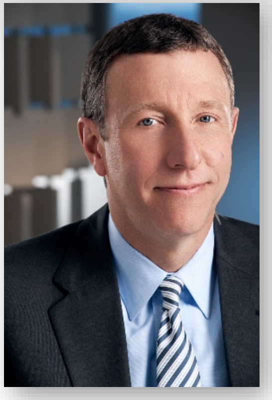

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Appendix

Legal Risks of Alternative Data:

Potentially Applicable Law in Two “Buckets”:

Data Regulation and Risk

- **Substantive regulation**
  - (HIPAA, GLBA, BDRR, CCPA, DOD)
- **Contractual restrictions**
- **Proprietary rights**
  - (Confidential information and trade secrets)
- **Civil duties**
  - (Fiduciary and civil duties from a “relationship of trust”)
- **Cybersecurity Regulation**
  - (DMCC, CFAA, etc.)
- **Jurisdictional and Geographic Regulation**
  - (Transfer restrictions and “data residency”)

Securities Regulation and Risk

- **“Insider” Trading**
  - (Title 15, CFTC §180.1)
- **“Outsider” Trading**
- **Breach of Duty Liability**
  - (Advisers Act Rule 206(4) §8, State Laws)
- **Unfair Business Practices**
  - (MA §93A, NY Martin Act)
- **Consistency with investor disclosure and Corporate compliance**

Alternative Data Risk Management Tools

1. Fund Disclosures

Supply Chain Cybersecurity

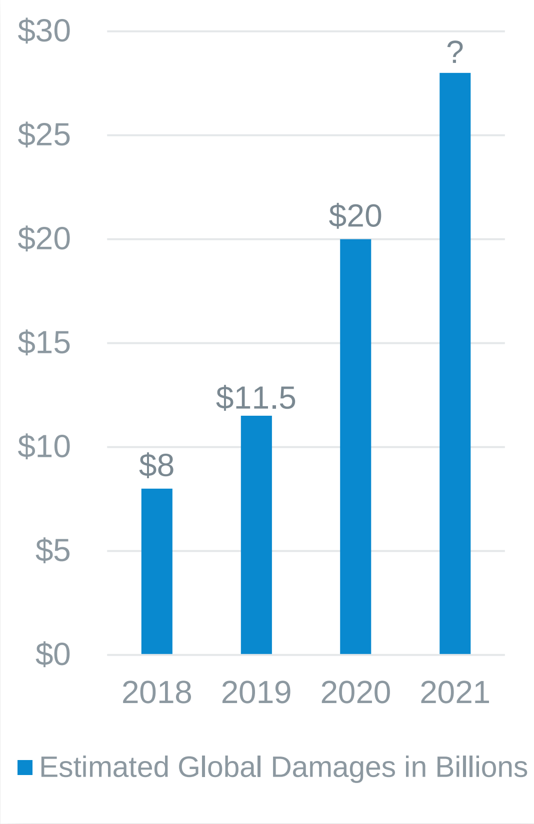
- You own the risk of your supply chain.
  - *SolarWinds:* Attack through established channels (MS, Vmware) *https://en.Wikipedia.org/wiki/2020_United_States_federal_government_data_breach*
  - Management of identity risk is key
- Tools:
  - Supply chain mapping
  - Vendor qualification procedures
    - At least a SIG
  - Required testing, audits, certifications
  - Event response planning

“Resiliency” Tools

- The traditional tools still required:
  - DR, cybersecurity, and reliability planning and design with periodic confirming third party testing, and incident response planning
- Specific concerns to mix in to anticipate 2021 priorities:
  - Management of identity risk and malware disruption in a COVID work remote environment
  - ESG Sensitivity: Plan should reflect an assumption that climate disasters will get worse in coming years and regional disruptions will be the norm
  - Responding to ransomware attacks
    - From a fiduciary perspective, cybersecurity is a reliability and investor protection issue
    - Ransomware insurance is insufficient, opposed by certain regulators, and, in any event, becoming less available

Ransomware Developments

- Ransom payments are under greater scrutiny
- OFAC Guidelines threaten $20 million fine for payments—even if unknowing—to a sanctioned entity
- In January, FBI Director Chris Wray encouraged companies to proactively work with law enforcement and noted OFAC will be lenient with parties that do pay a sanctioned entity if they timely and fully disclose the incident
- A proposed rule by FinCEN would require that financial intermediaries report the identity of parties involved in transactions valued over $10,000—even where the transaction is in a virtual currency
  - This change could have potential implications when ransom is paid using a cryptocurrency
- New York Department of Financial Services new guidelines urge insurers to increase underwriting standards



Source: purplesec.us/cyber-security-trends-2021

Tech in Digital Assets

- Digital Assets have attributes that raise general fiduciary issues apart from tech.
  - *Suitability, reliability of proper execution, etc.*
- **Tech Aspects** of Digital Assets to watch for in an examination setting in 2021 include:
  - Cybersecurity: The blockchain is immutable but every other aspect of tech enabled digital asset trading is hack-able
  - Failure to integrate compliance oversight into technology development and maintenance in exchange and custodial platforms
  - Trading through phone apps: 2021 priorities communications repeatedly emphasize *Robinhood* driven compliance concerns, including technology issues (cybersecurity, compliance oversight)

Divisions of Exams Focus on Digital Assets

- February 26, 2021 Division of Examinations Digital Asset Securities Risk Alert—Investment Adviser's examinations will focus on:
  - Portfolio management: how are your digital assets classified and diligenced? Is your fiduciary duty fulfilled?
  - Accurate books and Records: given the varying reliability of digital asset trading platforms, are your books and records accurate?
  - Custody: who has access to the private key? Has the asset been stolen? How are assets stored by trading platforms and custodians?
  - Risk disclosure: are investors aware of the unique risks posed by digital asset securities?
  - Valuation methodologies: how are digital assets valued and how does that impact advisory fee calculations?
  - Registrations issues: how are digital assets characterized and how does that impact the calculation of regulatory assets under management?

Digital Asset: Safety, Storage, and Custody

- How are the assets held?
  - If digital assets are being offered to clients, custody becomes a major issue
    - Are the digital assets in a hot wallet or cold storage?
  - Categorization impacts storage requirements:
    - If a security, then a qualified custodian is required—do the custodians have the proper qualifications?
      - What is their regulatory status?
      - Are they a bank that is being overseen?
      - Are they being audited?
      - As theft is a big concern—do they have insurance?

Digital Assets Controls and Supervision

- Know the provenance of the digital assets
  - Because they are largely fungible, money laundering is a concern
  - If you are establishing a fund where people can contribute crypto, there will be heightened anti-money laundering scrutiny
- Bitcoin and Ether aren't securities—but monitoring is still required
  - For example, employees still have an obligation not to front run client orders
  - This supervision is a part of the duty owed to the client—even though the asset is not a security
- Pre-clearance and holdings reporting
  - The security categorization determination will set requirements—better safe than sorry?
  - Problems posed by virtual currencies like Ether, which is often used in digital purchases: not every purchase should require pre-clearance or a report, but where do you draw the line?

FinTech/RegTech

- In light of fee compression there is a huge AM industry trend to automate the full AM life cycle (from the first front office customer contact through the deepest reaches of custodial and back office services).
- 2021 priorities communications emphasize the importance and risks of regtech
  - Automated systems need *compliance by design* or *built in compliance*
  - Yet *compliance by design* creates a risk of systemic failure (*Knight Capital, AXA Rosenberg*)
  - Be ready to identify the guard rails, audits, oversight tools, design principles, and other guidance that ensures that where compliant operation is a technical function (i) compliance has oversight of technology, and (ii) there is an effective plan for spotting and responding to system errors

Data Driven Risk Analytics

- How are data analytics used in examination, enforcement and compliance?
  - Large data sets and AI driven analytics are used to identify the real-world contexts in which misconduct and risk are greatest
  - Already used on both the enforcement side and the company side in global supply chain management (ESG, Anti-corruption, counterfeit goods)
  - More than just targeting: Audits, policies, penalties all driven off the analytics
  - Ropes & Gray's **Insights Lab** (https://www.ropesgray.com/en/RGInsightsLab)
- The SEC is adopting and will over time expect managers to have their own systems

Sites to Follow

- For Alternative Data: https://history.siia.net/Divisions/FISD-Financial-Information-Services-Association/Programs/Alternative-Data-Council
- For Fintech: https://www.sec.gov/finhub
- For Div. of Examination Risk Alerts, Staff Letters, etc.: https://www.sec.gov/exams
- For SEC Press Releases: https://www.sec.gov/page/news
- For the Div. of Examination 2021 Priorities: https://www.sec.gov/files/2021-exam-priorities.pdf

ESG Focus: Risk Alert, Exam Priority, Enforcement Focus and Possible Rulemaking

- SEC ESG Risk Alert (April 9)
  - SEC Exam Priorities Feature ESG (March 3)
- SEC Announces Enforcement Task Force Focused on Climate and ESG Issues (March 4)
  - Led by the Acting Deputy Director of Enforcement, Kelly L. Gibson, and will work closely with other SEC Divisions and Offices
  - "Will develop initiatives to proactively identify ESG-related misconduct."
  - Initial focus will be to identify any material omission or misstatements in issuers' disclosure concerning climate risks under existing rules. In addition, the Task Force will analyze disclosure issues and compliance shortfalls in investment advisers' and funds' ESG strategies.

Acting Commissioner Lee requests staff to "evaluate [the] disclosure rules with an eye toward facilitating the disclosure of consistent, comparable and reliable information on climate change." (March 15) To facilitate the staff's assessment, she has requested comment on numerous matters, including:

- "How the Commission can best regulate, monitor, review and guide climate change disclosures . . . ."
- "What information . . . can be quantified and measured?"
- "How should disclosures . . . be enforced or assessed?"

Public Announcement of ESG Exam Priorities

- Acting Chair Lee: "Enhanced focus on climate and ESG-related risks"
  - Do proxy voting policies and practices align with "investors' best interests and expectations?"
  - Business continuity plans in light of intensifying physical risks associated with climate change
  - Integrating climate and ESG considerations into the SEC's broader regulatory framework
- EXAMS Director Driscoll: "Our priorities reflect the complicated, diverse, and evolving nature of risks to investors and the markets, **including climate and ESG."**