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May 29, 2020

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COVID-19 Update

In addition to the items below, please refer to Davis Polk's "**Coronavirus Updates**" webpage for additional content related to the outbreak.

SEC Forms Cross-Divisional COVID-19 Market Monitoring Group

On April 24, 2020, the SEC announced the formation of an internal, cross-divisional COVID-19 Market Monitoring Group. According to the SEC, the temporary group will assist with (1) SEC actions and analysis related to the effects of COVID-19 on markets, issuers, and investors (including "Main Street" investors), and (2) responding to requests for information, analysis and assistance from fellow regulators and other public sector partners.

According to the SEC, the COVID-19 Market Monitoring Group will work closely with personnel from across the agency, including staff from the Division of Economic and Risk Analysis ("**DERA**"), the Division of Trading and Markets, the Division of Investment Management, the Division of Corporate Finance, the Office of Municipal Securities, the Office of Credit Ratings, the Office of Compliance Inspections and Examinations, the Office of International Affairs, the Office of the Chief Accountant and the SEC's Activities-Based Monitoring Committee. The group will also assist in the SEC's efforts to coordinate with other COVID-19-related federal working groups, including the President's Working Group on Financial Markets, the Financial Stability Oversight Council and the Financial Stability Board.

The COVID-19 Market Monitoring Group will be chaired by S.P. Kothari, the SEC's Chief Economist and Director of DERA. Jeffrey Dinwoodie, Chief Counsel and Senior Policy Advisor for Market and Activities-Based Risk in the Office of the Chairman, will assist Dr. Kothari in managing and coordinating the efforts of the group

- **See a copy of the Press Release**

Rules and Regulations

SEC Proposes to Modernize Framework for Registered Fund Valuation Practices

Summary

In an April 21, 2020 **release** (the "**Proposing Release**"),[1] the Securities and Exchange Commission (the "**SEC**") proposed new Rule 2a-5 under the Investment Company Act of 1940, as amended (the "**Investment Company Act**"). The proposed rule would establish a framework for good-faith determinations of the fair value of a registered fund's investments under Section 2(a)(41) of the Investment Company Act and Rule 2a-4 thereunder. Under the proposed rule, good faith determinations of fair value would require certain functions to be performed, such as:

- Assessing and managing material risks associated with fair value determinations, including material conflicts of interest;
- Selecting, applying and testing fair value methodologies;
- Overseeing and evaluating any pricing services used;
- Adopting and implementing policies and procedures; and
- Maintaining certain records.

According to the Proposing Release, proposed Rule 2a-5 is designed to address market developments in registered fund valuation practices, including the greater variety of asset classes held by registered funds, enhanced availability and volume of data used in valuation determinations, and increased use of third-party pricing services. The Proposing Release also recognizes the important role and expertise provided by registered fund advisers in the valuation process. Notably, proposed Rule 2a-5 would expressly permit a fund board to assign the valuation functions required under the proposed rule to the fund's investment adviser, subject to additional recordkeeping, reporting and other requirements designed to facilitate the board's oversight of the adviser's fair value determinations. Proposed Rule 2a-5 would also define when a market quotation would be considered "readily available" for purposes of Section 2(a)(41), and provide that for a registered fund that is a unit investment trust, the required valuation functions under the proposed rule be performed by the fund's trustee.

The SEC has requested public comments on the proposal, to be received by the SEC on or before July 21, 2020.

Key Takeaways

The proposals contained in the Proposing Release are discussed in greater detail below. Some key takeaways of the proposal include:

- Registered fund boards would expressly be permitted to assign fair value determinations to the fund's adviser.
- Requirements regarding segregation of an adviser's portfolio management from its valuation function, and additional reporting to fund boards, would increase regulatory compliance obligations for advisers, which may be burdensome for smaller investment advisers.

[1] *Good Faith Determinations of Fair Value*, SEC Release No. IC-33845 (April 21, 2020).

- Registered funds would likely need to review and revise their Rule 38a-1 policies to reflect new requirements under the new rule, if adopted.

Background

In the Proposing Release, the SEC emphasized that proper valuation of a registered fund's investments is critically important because it affects the accuracy of the fund's NAV calculation and supports the purchase and sale of the fund's shares at fair prices. Proper valuation of a registered fund's investments also promotes accuracy in the fund's fee calculations, disclosures to investors regarding performance and fees, and compliance with investment policies and limits required under the Investment Company Act. For these reasons, federal securities laws impose liability on registered funds, fund boards and advisers for improper valuations of fund investments and material misstatements regarding a fund's valuation process. The SEC noted in the Proposing Release that it last issued guidance regarding valuation in 1970,[2] and that certain market and regulatory developments[3] since then have significantly altered how registered funds, fund boards, advisers and other fund service providers perform fair value determinations. For example, the SEC noted that the increased complexity of fund portfolios and data used for valuations have led many fund boards to seek clarity on how they can "effectively fulfill their fair value determination obligations while seeking the assistance of others."[4] In light of these developments, the SEC is proposing Rule 2a-5 to provide a consistent framework, as further described below, for valuation practices across registered funds, and to allow fund boards to assign fair value determinations to the fund's adviser with effective board oversight.

Proposed Rule 2a-5 Requirements

Determination of Fair Value

Under proposed Rule 2a-5, a good faith determination of fair value for purposes of Section 2(a)(41) of the Investment Company Act and Rule 2a-4 thereunder would require performance of the following functions:

Assess and Manage Risks: Proposed Rule 2a-5 would require periodic assessment of valuation risks, including material conflicts of interest. Other than conflicts of interest, the proposed rule does not prescribe the specific risks that must be addressed to satisfy the rule because, as stated in the Proposing Release, the SEC believes that the valuation risks for each particular fund would depend on the facts and circumstances of such fund's investments. The Proposing Release suggested that the sources of valuation risk for a fund could include:

- The types of investments held or intended to be held by the fund;
- Potential market or sector shocks or dislocations (e.g., significant changes in short-term volatility, market liquidity, trading volumes or sudden increase in trading suspensions);
- The extent to which a fund's fair value methodology uses unobservable inputs, particularly if provided by the fund's adviser;

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[2] Accounting Series Release 113, SEC Release No. IC-5847 (Oct. 21, 1969) ("**ASR 113**"); Accounting Series Release 118, SEC Release No. IC-6295 (Dec. 23, 1970) ("**ASR 118**"). If proposed Rule 2a-5 is adopted, the SEC proposes to rescind ASR 113, ASR 118 and certain other SEC staff letters relating to valuation that would be superseded or inconsistent with the rule.

[3] For example, the establishment of the Public Company Accounting Oversight Board under the Sarbanes-Oxley Act of 2002, the adoption of compliance Rule 38a-1 under the Investment Company Act and Rule 206(4)-07 under the Investment Advisers Act of 1940, and issuance of FASB guidance on fair value under US GAAP.

[4] Proposing Release, at 14.

- The proportion of a fund's investments that are fair valued in good faith, and their contribution to the fund's returns;
- Use of third-party service providers: e.g., service providers with limited expertise in relevant asset classes; use of fair value methodologies that rely on inputs from third-party service providers; use of third-party service providers that rely on their own service providers; and
- Inappropriate fair value methodologies, or inconsistent or incorrect application of such methodologies.

Proposed Rule 2a-5 also does not prescribe a required frequency for the periodic assessments of valuation risks. In the Proposing Release, the SEC stated its belief that different frequencies may be appropriate for different funds depending on the fund's valuation risks, and that the periodic assessments should take into account factors such as changes in fund investments, significant changes in fund investment strategies or policies, and market events.

Establish and apply fair value methodologies: Proposed Rule 2a-5 would require selecting, and consistently applying, appropriate fair valuation methodologies, which would include specifying (1) the key inputs and assumptions for each asset class or portfolio holding,[5] and (2) the methodologies that will apply to new types of investments in which the fund intends to invest.[6] The proposed rule would also require periodic review and adjustment, if needed, of the selected methodologies. The Proposing Release does not specify a particular valuation methodology to be used (recognizing that the methodology would depend on the facts and circumstances of each investment, the relevant market and market participants), but clarified that to be appropriate under the proposed rule, the methodology used must be consistent with the valuation approaches set forth in FASB ASC Topic 820. The proposed rule would also require the board or adviser, as applicable, to monitor for circumstances that may require fair valuation, and establish criteria for determining when market quotations are no longer reliable and readily available.

Test fair value methodologies: Proposed Rule 2a-5 would require testing of the appropriateness and accuracy of the fair value methodologies selected, including identifying the testing methods to be used and the frequency of testing.[7]

Evaluate pricing services: Proposed Rule 2a-5 would require oversight of pricing services used, which would include establishing a process for approving, monitoring and evaluating each pricing service provider and the criteria for initiating pricing challenges. The Proposing Release stated that such evaluation should take into account factors such as:

- Qualification, experience and history of the pricing service;

[5] As an example, the Proposing Release stated that it would not be sufficient under the proposed rule "to simply state that private equity investments are valued using a discounted cash flow model, or that options are valued using a Black-Scholes model, without providing any additional detail on the specific qualitative and quantitative factors to be considered, the sources of the methodology's inputs and assumptions, and a description of how the calculation is to be performed (which may, but need not necessarily, take the form of a formula)." Proposing Release, at note 45.

[6] As an example, the Proposing Release stated that "the board or adviser, as applicable, generally should address, prior to the fund's investing in a new type of investment, whether readily available market quotations will be used or if the investment may need to be fair valued on occasion or at all times . . . The board or adviser generally should seek to identify sources of price inputs before the fund invests in such asset classes, if possible, in addition to determining an appropriate fair value methodology, and generally should document these decisions." Proposing Release, at note 49.

[7] As an example, the Proposing Release stated that "if a fund invests in securities that trade in foreign markets, the board or adviser generally should identify and monitor for the kinds of significant events that, if they occurred after the market closes in the relevant jurisdiction but before the fund prices its shares, would materially affect the value of the security and therefore may suggest that market quotations are not reliable." Proposing Release, at 21-22.

- Valuation methods or techniques, inputs or assumptions (e.g., whether inputs or assumptions are provided by the fund's adviser) used by the pricing service for different classes of holdings and how they are affected by changing market conditions;
- Process for considering pricing challenges, including how information received from such challenges are incorporated into the pricing service's pricing information;
- Potential conflicts of interest of the pricing service, and how the pricing service mitigates such conflicts; and
- The testing processes used by the pricing service.

Fair value policies and procedures: Proposed Rule 2a-5 would require adoption and implementation of written policies and procedures reasonably designed to achieve compliance with the proposed rule. If a fund board assigns fair value determinations to an adviser, the policies and procedures required under the proposed rule would be adopted and implemented by the adviser, subject to board oversight under Rule 38a-1. The Proposing Release clarifies that if the adviser's fair valuation policies and procedures under Rule 2a-5 would be duplicative of the fund's valuation policies under Rule 38a-1, the fund could adopt the adviser's Rule 2a-5 policies and procedures to fulfill its Rule 38a-1 obligations.

Recordkeeping: Proposed Rule 2a-5 would require a registered fund to maintain supporting documentation for fair value determinations for five years, with the first two years in an easily accessible place, and a copy of policies and procedures required under the rule for five years in an easily accessible place. According to the Proposing Release, the recordkeeping requirement is designed to be consistent with recordkeeping requirements under Rule 38a-1(d).

Performance and Assignment of Fair Value Determinations

Under proposed Rule 2a-5, a registered fund's board may choose to perform the required fair valuation functions itself, or assign such functions (subject to board oversight) to the fund's primary adviser or to one or more of its sub-advisers.[8] In the Proposing Release, the SEC stated that the board's oversight of the assigned valuation function should not be a passive activity,[9] and that a fund board should use a level of scrutiny appropriate for the fund's valuation risks, including the extent to which valuations depend on subjective inputs and assumptions. In particular, the SEC emphasized that the board should serve as "a meaningful check on the conflicts of interest of the adviser and other service providers involved in the determination of fair values" who may have an incentive to improperly value a fund's investments to increase fees, improve or smooth reported returns, comply with fund investment policies or restrictions, or maintain favorable business relationships with the adviser.[10]

Reports to the Board

To help ensure that a fund board receives the amount and type of information needed to carry out its oversight responsibilities, proposed Rule 2a-5 would require an adviser to provide the following reports to the board:

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[8] The Proposing Release clarified that if the valuation functions are assigned to multiple advisers, the fund's Rule 38a-1 compliance policies and procedures should address the increased complexities involved with overseeing multiple advisers

[9] For example, the Proposing Release noted that fund boards should "probe the appropriateness of the adviser's fair value process" and periodically review the "financial resources, technology, staff, and expertise of the assigned adviser, and the reasonableness of the adviser's reliance on other fund service providers, relating to valuation." Proposing Release, at 37.

[10] Proposing Release, at 36.

- Written assessments, at least quarterly, of the adequacy and effectiveness of the adviser's fair value process for the assigned portfolio, which must include at a minimum:
    - Assessment and management of material valuation risks, including material conflicts of interest of the adviser and any other service provider;
    - Any material changes to, or material deviations from, the fair value methodologies established under the proposed rule;
    - Results of the testing of such fair value methodologies, as required under the proposed rule;
    - Adequacy of resources allocated to the fair value process for the assigned portfolio, including material changes to roles or functions of persons responsible for determining fair value;
    - Material changes to the adviser's process for selecting and overseeing pricing services, and material events related to the adviser's oversight of pricing services (e.g., changes in service providers or price overrides); and
    - Any other materials requested by the board related to the adviser's process for making fair value determinations.

  The Proposing Release emphasized that these periodic reports are intended to supplement, not replace, the board's oversight responsibilities, and that boards should request any other information they feel is necessary to carry out such oversight (e.g., summaries of price challenges and overrides, back-testing data, reports on stale prices and pricing errors, adviser due diligence reports on pricing services, auditor testing results, trend analysis).

- Prompt reporting of matters (no later than three business days after the adviser becomes aware of the matter) related to the adviser's fair value process that materially affect, or could have materially affected,[11] the fair value of the assigned portfolio, including a significant deficiency or material weakness in the design or implementation of the adviser's process or material changes in the fund's valuation risks.

Specified Responsibilities and Segregation of Portfolio Management

Proposed Rule 2a-5 would require the adviser to specify the titles of persons responsible for making fair value determinations of the assigned portfolio, including the functions for which they are responsible. The Proposing Release noted that the adviser's policies and procedures should also describe the composition and role of its valuation committee or similar body, and identify persons responsible for handling price challenges and authorized to override prices, and their roles and responsibilities.

Proposed Rule 2a-5 would also require an adviser to reasonably segregate its fair value process from portfolio management of the fund. The Proposing Release emphasized that because portfolio managers are often compensated based on a fund's returns, they may have incentives that conflict with the fund's interests. Therefore, reasonable segregation is needed to promote effectiveness of the fair value process. However, the SEC also recognized that the portfolio managers for a fund may have the most knowledge

[11] The Proposing Release clarified that "could have materially affected" was intended to capture situations where, among other things, a matter was detected that affected one security, which was not material on its own, but could have materially affected the larger assigned portfolio or a subset, if the matter had not been detected. The concept was not intended to require reporting where, "at the time a matter is detected, it did not seem that the matter would materially affect the fair value of the assigned portfolio but the matter later ended up having such an effect." Proposing Release, at 49.

of a fund's portfolio to be able to provide useful input and insight in the fair value process. The Proposing Release clarified that Rule 2a-5 is not intended to prevent portfolio managers from being able to provide such input and insight, or to require that portfolio managers be subject to a strict communications firewall. Instead of taking a prescriptive approach, the proposed rule allows reasonable segregation to be "tailored to each fund's facts and circumstances, including the size and resources of the fund's adviser" and may use a variety of methods, such as independent reporting chains, oversight arrangements, or separate monitoring systems and personnel.[12]

Records of Assignment

To facilitate the board's oversight of an adviser's fair value determinations, proposed Rule 2a-5 would also require funds to maintain copies of reports and other information provided to the board as required under the rule, and lists of investments or investment types whose fair value determinations have been assigned to the adviser. The records are required to be kept for five years, with the first two years in an accessible place.

Readily Available Market Quotations; Unit Investment Trusts

Under proposed Rule 2a-5, a market quotation will be considered "readily available" for purposes of Section 2(a)(41) if it is a quoted price in active markets for identical securities that the fund can access at the measurement date, and that is not unreliable. In the Proposing Release, the SEC stated its belief that to be appropriate under the proposed rule, a fair value methodology must be determined in accordance with US GAAP. Therefore, a quote would be considered unreliable under proposed Rule 2a-5 if US GAAP would require adjustments or consideration of additional inputs to determine fair value. The Proposing Release also clarified that evaluated prices, indications of interest, and accommodation quotes would not be considered "readily available" market quotations under the proposed rule.

If the registered fund is a unit investment trust, the proposed rule would require the fund's trustee to perform the valuation functions described above because a unit investment trust does not have a board of directors or an adviser.

Transition Period

The SEC proposed a one-year transition period from the date of publication of any final rule in the *Federal Register* to provide time for registered funds and their investment advisers to prepare for compliance with the final rule.

Industry Update

Commissioner Elad L. Roisman delivers remarks before the Council of Institutional Investors' Conference

On March 10, 2020, SEC Commissioner Elad L. Roisman delivered remarks at the Council of Institutional Investors' Spring 2020 Conference. Commissioner Roisman focused his remarks on the proxy process, noting that since the SEC announced a comprehensive review of the rules that govern the proxy system, the SEC has 1) "clarified and reaffirmed key aspects of investment advisers' fiduciary duty," including as it relates to voting proxies and using the services of proxy voting advice businesses, 2) "reaffirmed its longstanding interpretation that, in general, voting advice provided by these businesses falls within the definition of 'solicitation,'" 3) proposed amendments to the exemptions from the Exchange Act proxy solicitation rules, "which are tailored to these businesses' voting advisory services and take into account

[12] Proposing Release, at 54.

current market practices," and 4) "proposed updated eligibility criteria for shareholders to submit proposals to be included in a company's proxy materials." Noting that many commenters have provided feedback on the SEC's proposed rulemakings related to the proxy process, Commissioner Roisman continued his remarks by discussing his impressions on the feedback commenters have provided to the SEC's proxy voting advice proposal.

Proxy Voting Advice Proposal

Commissioner Roisman remarked that the SEC's proposal to include a period during which all soliciting parties have an opportunity to review and provide feedback on a proxy voting advice business's voting advice, prior to that advice being distributed to the business's clients, may, in the view of many commenters, "disrupt current voting practices" by decreasing the time available for clients to review the advice. Commissioner Roisman noted that he is taking this feedback seriously, including proposals by commenters to allow for a contemporaneous review period for companies, wherein a proxy voting advice business would "(1) send its report to the issuer at the same time it distributes the report to its clients and then (2) notify its clients if the issuer raises objections to the report within a short time period (e.g., some have suggested two days)." Commissioner Roisman indicated that he was interested in better understanding how the contemporaneous review period proposal "might work in light of certain voting practices of proxy advice business clients" including the use of electronic ballot pre-population of voting recommendations and automatic submission services. In addition, Commissioner Roisman also noted that he is considering, in response to commenter feedback, whether the SEC's proposal of "a time period during which the proxy voting advice business would have to disable any automatic submission features, in order to be eligible for the relevant exemptions" as an alternative to the proxy advice feedback requirement may address some of his concerns regarding the feedback proposal.

Commissioner Roisman continued by discussing the proposed conflicts of interest disclosure—as noted in the proposing release for the amendments, proxy voting advice businesses "engage in activities or have relationships that could affect the objectivity or reliability of their advice, which may need to be disclosed in order for their clients to assess the impact and materiality of any actual or potential conflicts of interest with respect to a voting recommendation."[13] Specifically, Commissioner Roisman noted that the reliance by proxy voting advice businesses on a sub-set of their clients in the development of their "off-the-shelf voting guidelines" makes sense, but raises questions as to whether some clients have greater visibility into and ability to influence the development of the proxy voting advice businesses' recommendations generally and whether more passive clients understand the possibility of this involvement by this sub-set of clients. In Commissioner Roisman's view, distinct shareholders could have varying interests in proxy voting that may lead them to desire different outcomes and, therefore, "there should be greater transparency about how this voting advice is developed."

More Work Ahead

Commissioner Roisman continued by discussing more work, that, in his view, the SEC "could do to improve the proxy process, beyond either of [the SEC's] current rule proposals."

Commissioner Roisman first remarked that, even if proxy voting advice businesses "were to disclose all of their material conflicts of interest, and even if they were to provide their clients with easy and timely access to issuers' views on their recommendations, there may be market participants who ignore that information and outsource their voting decisions to these businesses, without appropriate diligence or oversight." To address this potential issue, Commissioner Roisman suggested that the SEC focus more

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[13] *Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice*, SEC Release No. 34-87457 (Nov. 5, 2019), at 27.

examinations on determining how such market participants that are registered investment advisers are fulfilling their fiduciary duty to their clients.

Commissioner Roisman continued by discussing his concern “that shareholders, acting through voting advice businesses, are operating as ‘groups’ in our securities markets for purposes of our beneficial ownership rules.” He noted that such coordination may be an evasion of the disclosure goals of Exchange Act Section 13(d), which was meant to “require disclosures of certain information by any person, or, importantly, a group of persons, who acquire beneficial ownership of more than five percent of a publicly-traded company’s equity securities,” and the SEC’s adoption of Regulation 13D and requirement to file a Schedule 13D “with information about who these shareholders in the group are, their interests in the company’s securities, the purpose of the transaction, and any plans or proposals relating to certain significant action.” Commissioner Roisman contended that the SEC has been clear that “when two or more persons agree to act together for the purpose of voting their shares, a group has been formed for purposes of [the SEC’s] beneficial ownership rules” regardless of whether such action was coordinated through an intermediary like a proxy voting advice business. Commissioner Roisman encouraged the SEC to explore whether further action is needed to ensure that the disclosure requirements of Regulation 13D are not circumvented in this context and encouraged market feedback on this issue.

Commissioner Roisman then turned to the SEC’s “proxy plumbing” framework and the suggestion by some commenters that the SEC should focus on reforms in that area. Noting that proxy plumbing is “anything but simple,” Commissioner Roisman remarked that proxy plumbing is an area “where many different types of actors are intertwined and entrenched in their current roles and have been for several decades.”

Commissioner Roisman first provided a basic explanation of the current proxy plumbing system. A company must distribute proxy materials to all of its shareholders, including those who do not hold their shares directly, which is the vast majority of investors in U.S. companies, he said. Those shares, Commissioner Roisman explained, are held through an intermediary nominee. Accordingly, he explained that the company must contact DTC to receive a list of the intermediaries and then request from each intermediary “information about how many of the intermediary’s customers are beneficial owners of the company’s shares.” Then, Commissioner Roisman explained, the company can provide the intermediaries with the appropriate number of proxy materials to be provided to the beneficial owners.

Complicating matters, Commissioner Roisman explained, is the practice of intermediaries to loan out their customers’ shares, which “potentially transfers the customers’ voting rights to someone else.” Furthermore, Commissioner Roisman remarked, intermediaries may have a financial incentive to request a greater number of materials to be provided by the company, “which may result in the intermediary casting more votes than its customers are actually entitled to.” Commissioner Roisman explained that this system results in companies (and ultimately, their shareholders) paying for the distribution by the intermediaries of the proxy materials and the collection of customers’ voting instructions, even though the company will have no knowledge or control over “whether the intermediaries have provided an accurate beneficial owner count or distributed the materials only to those people who actually have the voting entitlement.” He continued by noting that companies willing to engage in some of this work themselves to reduce costs will face challenges doing so, including limited access to the identity and contact information of its beneficial owners due to the objecting beneficial owner/non-objecting beneficial owner (“**OBO/NOBO**”) framework.

Commissioner Roisman also noted that many market participants believe that the market would benefit from end-to-end voting confirmation, which would allow a shareholder to confirm that its vote has been properly counted, but no consensus has been reached on who should pay for that service. He also remarked that many commenters have suggested changes to the OBO/NOBO framework and to the role of nominee intermediaries. Commissioner Roisman concluded his remarks on proxy plumbing by noting that these questions “are not simple, but they are important.” He remarked that group engagement on these issues could "help [the SEC] study options for change," which should be designed "to serve the interests of the ultimate retail investors who have invested in our public companies."

Finally, in concluding his remarks on the proxy process, Commissioner Roisman indicated that he has come to believe that the SEC should consider adopting a universal proxy rule, noting that "there seems to be growing consensus that a universal proxy rule could provide benefits to everyone involved in a proxy contest, most importantly, the investors being solicited" and encouraged market participants to continue to provide feedback and suggest potential reforms.

- **See a transcript of his remarks**

Litigation

SEC Charges Private Equity Firm with Compliance Failures Relating to Investment in Publicly Traded Company

On May 26, 2020, the SEC issued an order (the "**Order**") instituting and settling cease-and-desist proceedings against a private equity firm (the "**PE Firm**") arising out of alleged deficiencies in the PE Firm's compliance policies and procedures relating to possession of potential material non-public information ("**MNPI**") obtained through the PE Firm's investment in a publicly traded company (the "**Portfolio Company**"). The SEC alleges that the PE Firm's compliance policies and procedures intended to ensure that the PE Firm would not trade in the securities of an issuer while in possession of potential MNPI of that issuer, and its compliance staff's implementation of those policies, did not sufficiently account for the "special circumstances" posed by the PE Firm's investment in the Portfolio Company, and the PE Firm employee's "dual role" as both a board member of the Portfolio Company and a deal team member who participated in the PE Firm's trading decisions concerning the Portfolio Company.

According to the Order, in 2016 the PE Firm invested "several hundred million dollars" in debt and equity of the Portfolio Company. The PE Firm obtained the right to appoint two representatives to the board of directors of the Portfolio Company, and appointed "a senior member of its 'deal team'" to the Portfolio Company's board.

The PE Firm's compliance policies and procedures in place in 2016 defined MNPI and established "Trading Procedures" with respect to potential possession of MNPI. Under the PE Firm's trading procedures, the PE Firm established a restricted list of securities subject to trading restrictions; any company for which a PE Firm-managed fund had a control position or personnel serving as a board member—including the Portfolio Company—was placed on the restricted list. As described in the Order, the PE Firm imposed a "hard stop" on any potential trades in securities on the restricted list. The Order explains that the PE Firm's procedures required that its compliance staff review and approve any trade in a security on the restricted list before such trade was executed, and required compliance staff to "follow up with the relevant parties to gather additional information," consider relevant factors, and, if a PE Firm appointee served as a director of a publicly listed company, confirm that the company's trading window was open and "check with [the PE Firm] director for MNPI."

After the PE Firm made the debt and equity investment described above, and appointed two members of Portfolio Company's board, the PE Firm also purchased "over 1 million shares" of the Portfolio Company's publicly traded stock, which the SEC states made up "approximately 17% of available or 'public float' shares." The SEC alleges that, during the period in which the PE Firm purchased publicly traded shares, the PE Firm employee serving on Portfolio Company's board received information that "was at risk of being MNPI." Such information included information relating to Portfolio Company's "potential changes to senior management," "mid-quarter hedging adjustments," "efforts to sell its passive interest in a specific asset," "interest in selling equity and using the proceeds to retire certain debt," and the "decision to pay quarterly loan interest to [the PE Firm] 'in kind' versus in cash."

As alleged in the Order, the PE Firm had placed Portfolio Company on the restricted list and followed certain of its procedures relating to trading in securities on its restricted list. However, the SEC alleges several failures to follow compliance policies, or deficiencies in compliance polices in place, and failure to appropriately address the risk that the PE Firm was in possession of MNPI of Portfolio Company, e.g.:

- Compliance policies and procedures left implementation to the discretion of compliance staff, and did not specifically direct compliance staff to assess whether a PE Firm employee serving as a director shared information with other PE Firm employees, or to confirm "the full spectrum of [PE Firm] employees who could have acquired" potential MNPI;
- Compliance staff were "less familiar" with the special circumstances presented in the case of Portfolio Company because the PE Firm "had not commonly held director seats on the boards of publicly listed companies";
- Compliance staff "failed to provide entries" in the PE Firm's order management system "sufficiently documenting" whether compliance staff had inquired with the PE Firm employee serving on Portfolio Company's board and the relevant deal team whether they had obtained MNPI from Portfolio Company or any other source, by virtue of the PE Firm employee's board service or under the terms of the PE Firm's debt investment in Portfolio Company;
- Compliance staff's entries in the order management system explaining reasons for approving a trade "lacked consistency and detail," and thus did not demonstrate that the PE Firm "properly assess[ed] the heightened risks presented by trading in the public markets in the securities of the Portfolio Company";
- Compliance policies and procedures did not specifically address the "special circumstances" presented where a member of the PE Firm deal team served as a director of a public company, and where that member of the deal team and director "remained involved" in the PE Firm's trading decisions.

The Order reports that after the SEC's investigation commenced, the PE Firm retained an outside consultant to review and evaluate its compliance policies and procedures concerning potential MNPI of public portfolio companies. The PE Firm also expanded the size and authority of compliance teams, standardized compliance procedures for determining whether the firm has access to MNPI, and enhanced training programs. The Order also notes that the PE Firm cooperated in the SEC's investigation.

As a result of the conduct alleged, the SEC charged the PE Firm with violating Section 204A of the Investment Advisers Act of 1940, as amended (the "**Advisers Act**") which requires investment advisers subject to Section 204 of the Act with establishing, maintaining, and enforcing written policies and procedures to prevent the misuse of MNPI; with violating Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which requires registered investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and rules thereunder. The PE Firm agreed to be censured, to cease and desist from future violations, and to pay a civil money penalty of $1 million.

- **See a copy of the Order**

SEC Charges Private Fund Manager with Custody Rule Violations Arising from Failures to Distribute Audited Financial Statements

On May 22, 2020, the SEC issued an order (the "**TSP Order**") instituting and settling cease-and-desist proceedings against TSP Capital Management Group, LLC ("**TSP**"), a registered investment adviser, arising out of TSP's alleged failure to timely distribute audited financial statements prepared in accordance with GAAP from 2014 through 2018, or to retain an auditor for years after 2015, in violation of

Section 206(4) of the Advisers Act and Rule 206(4)-2 thereunder (commonly referred to as the "**Custody Rule**").

According to the TSP Order, TSP managed two private funds during the relevant period; the largest fund was named Cameroon Enterprises, LLC Fund (the "**Cameroon Fund**"). From 2014 through 2018, TSP sought to comply with Rule 206(4)-2 with respect to the Cameroon Fund using the so-called "Audited Financials Alternative," which required, among other things, that the Cameroon Fund and TSP engage a PCAOB-registered firm to audit the financial statements of the Cameroon Fund at least annually, and that TSP distribute the Cameroon Fund's audited financial statements prepared in accordance with GAAP to all limited partners within 120 days of the end of the fund's fiscal year.

The SEC alleges that TSP did engage a PCAOB-registered auditor to conduct an annual audit of the Cameroon Fund's financial statements for 2014 and 2015, but that the audit report for 2014 was sent to investors 686 days late and that the 2015 audit report was sent to investors 927 days late. For the following years, TSP allegedly failed to engage an auditor or distribute audited financial statements to investors in the Cameroon Fund. The SEC further alleges that TSP failed to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and rules thereunder.

Based on the conduct described above, the SEC charged TSP with violations of Section 206(4) of the Advisers Act, and Rules 206(4)-2 and 206(4)-7 thereunder. TSP agreed to be censured, to cease and desist from future violations, and to pay a civil money penalty of $60,000.

- **See a copy of the TSP Order**

SEC Charges Investment Adviser with Alleged Valuation Errors Leading to NAV Overstatement

On April 28, 2020, the SEC issued an order (the "**Semper Order**") instituting and settling cease-and-desist proceedings against Semper Capital Management, L.P. ("**Semper**"), a registered investment adviser, arising out of Semper's valuation practices for odd lot positions in mortgage-backed securities ("**MBS**") held by a mutual fund that Semper managed (the "**Fund**"). Semper allegedly allowed its odd lot MBS positions to be valued using marks for larger, "round lot" positions, which, in turn, resulted in inflation of the fund's NAV and performance record.

As stated in the Semper Order, during the relevant period of July 2013 through May 2014, the Fund's investments consisted almost entirely of odd lot bond positions, largely in MBS. The SEC alleges that after Semper caused the Fund to purchase odd lot positions, Semper would report the purchase to the Fund's fund administrator; the fund administrator would obtain prices for the bonds from one or more third-party pricing vendors. According to the Semper Order, these third parties would routinely provide prices for "round lots" of the relevant security, which prices were typically higher than the prices for odd lots and higher than Semper's purchase price.

The SEC alleges that Semper was aware that the pricing marks provided by third-party pricing vendors resulted in markups of its position, and knew that the prices provided were inaccurate. Under the applicable procedures, if Semper believed that the price provided by a third party was "not reflective of the present value of a security," Semper could issue a "price challenge," to which the third-party pricing vendor would respond by increasing, decreasing, or holding constant the price of a security. When Semper issued price challenges with respect to odd lot positions, the vendors informed Semper that their pricing was based on round lot prices, not odd lot prices. The SEC contends that Semper should have understood that its positions were being priced at round lot prices at a premium to the price of odd lot positions.

According to the SEC, the effect of this pricing practice was to inflate the Fund's NAV by as much as $0.49 per share. This inflation resulting from the use of round lot pricing for odd lots significantly improved the Fund's reported performance over the relevant period—according to the Semper Order, from July 22, 2013 to May 31, 2014, 32% of the Fund's inception-to-date returns were attributable to its markups of odd lot positions to the higher round lot prices.

The alleged inflation in performance and pricing allegedly rendered misleading Semper's statements about the Fund's performance and Semper's skill in managing the Fund, as Semper did not disclose that its pricing practices were responsible for a significant portion of the Fund's apparent performance. The SEC also contends that Semper's compliance manual did not explain, among other things, how to include information about pricing and valuation considerations in public disclosures, and was therefore not reasonably designed to prevent inaccurate statements like those Semper made about the causes of the Fund's performance.

As a result of this alleged conduct, the SEC charged Semper with violations of Section 206(4) of the Investment Advisers Act of 1940 and Rules 206(4)-7 and 206(4)-8 thereunder, Section 34(b) of the Investment Company Act, and Rule 22c-1 under the Investment Company Act. Semper agreed to pay $103,228 in disgorgement—the amount of advisory fees Semper earned managing the Fund during the relevant period—$25,000 in prejudgment interest, and a civil monetary penalty of $375,000. Semper also agreed to be censured and to cease and desist from future violations.

- **See a copy of the Semper Order**

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