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CLIENT MEMORANDUM

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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**

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 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."[1] 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."

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

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 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**

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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