Proskauer

SEC Risk Alert Highlights Renewed Focus on Insider Trading and MNPI Policies and Procedures for Fund Managers

The Capital Commitment Blog on **May 5, 2022**

Last month, we predicted that a renewed focus by the SEC on insider trading, MNPI and related internal controls would be one of the Top Ten Regulatory and Litigation Risks for Private Funds in 2022. Last week, the SEC's Division of Examinations ("EXAMS") issued a timely risk alert relating to Investment Adviser Material Non-Public Information (MNPI) Compliance Issues.

The SEC's EXAMS risk alert specifically highlighted a handful of common deficiencies noted under Section 204A of the Advisers Act and Rule 204A-1 under the Advisers Act (the "Code of Ethics Rule").

- Both *registered and unregistered investment advisers* (such as those qualifying as Exempt Reporting Advisers under the "venture capital" exemption) are subject to Section 204A of the Advisers Act. This provision requires advisers to establish, maintain and enforce written policies and procedures to prevent the misuse of MNPI.
- *Registered investment advisers* are also subject to the Code of Ethics Rule. Under this rule, RIAs must adopt a written "code of ethics" governing certain standards of business conduct, identifying "access persons" (*e.*, certain supervised persons as defined in the Rule), and requiring reporting of personal securities transactions and holdings by those access persons.

The risk alert notes certain issues under Section 204A, serving as a reminder that the EXAMS staff expects to see these written policies and procedures implemented and enforced by registered and unregistered advisers:

- Alternative Data: If a fund manager uses alternative data, the staff expects written procedures to address the potential risk of MNPI through those data sources. The staff expects due diligence on vendors to be memorialized (and updated as needed), and that the diligence should address underlying terms and conditions

relating to the acquisition and use of particular data sets. The staff also expects that procedures relating to alternative data onboarding should be consistently applied.

- Value-Add Investors: The EXAMS staff continues to expect firms to have procedures relating to "value-add investors" in private funds, such as LPs that are investment bankers, officers or directors at public companies, or principals or portfolio managers at asset management firms. The staff views these investor relationships as having increased risk relating to MNPI, and generally expects to see procedures to identify these investors and to monitor or manage communications with them.
- Expert Networks: This topic is not a new one. The EXAMS staff expects implementation of policies and procedures relating to expert network consultants, including procedures to log calls, review notes from calls, and monitor trading activity by supervised persons in securities in similar industries as those discussed during calls (calling to mind the SEC's recent "shadow trading" enforcement action.

With respect to the Code of Ethics Rule, the staff noted a number of compliance issues that should be top of mind for registered advisers:

- Identification of access persons: Procedures should define and identify the firm's access persons, which include all officers, directors and partners for most advisers, as well as other supervised investment professionals under Advisers Act Rule 204A-1(e)(1).
- Requiring pre-approval for certain investments: The risk alert specifically noted deficiencies for firms that did not pre-approve access persons' purchases of IPOs or limited offerings, as required by the Rule.
- Personal securities transactions and holdings: The alert reminded advisers that the Code of Ethics Rule requires documentation of holdings and transactions, which should be reviewed by the CCO (or a designee, for the CCO's holdings).

The primary focus is whether advisers are enforcing policies and procedures reasonably designed to prevent the misuse of MNPI under Section 204A of the Advisers Act, which the enforcement staff has used to bring enforcement actions focused on compliance violations, even without bringing insider trading charges. Asset managers should note that Risk Alerts often serve as a precursor to heightened focus by the examination staff, and potentially a greater risk of referrals to the SEC's Enforcement Division.

View Original

Related Professionals

- **Joshua M. Newville**
  Partner