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# 2019 Second Quarter Compliance Letter

*SEC Exams, Enforcement Actions, Guidance, & More for Investment Advisers*

Issued: July 8, 2019

Whether you're a rock climber or not, you have to admire Alex Honnold, the subject of the Academy Award-winning documentary film, *Free Solo*, and his ropeless climb of Yosemite National Park's 3,000-foot-tall El Capitan rock formation. One of the many captivating aspects of the film is Alex's approach to risk. He does something that, to most people on the planet, is completely insane, reckless, and suicidal. Yet, by the end of the movie he has demonstrated that he's none of those things.

And while this type of climb still requires Alex to make peace with the possibility of the ultimate consequence, he has, through skill, training, and preparation, mitigated his personal risk to a level that is acceptable, not only to him, but also to those closest to him—his girlfriend, mother, and climbing friends who know and love him enough to support his dream regardless of the potential consequences.

As a risk professional, I see many parallels between the worlds of investment management and rock climbing: Advising others on their investments or implementing compliance controls involves management and communication of risk/reward and consequences. And in both worlds, you can take something that is potentially unsafe and make it less risky through protection, awareness, planning, and skill.

So while, as an investment adviser, you may sometimes feel as though you are dangling from a staggering precipice with little to no support, the controls we use as an industry provide us with the safety net necessary to ascend even the most daunting of climbs with mitigated and manageable risk.

## Back to this quarter's headlines:

- In April, OCIE issued a risk alert that discussed common exam deficiencies related to safeguarding consumer records and information, including a failure to provide initial and annual Privacy Notices and opt-out notices, as well as a lack of policies and procedures required by the Safeguard Rule.
- In May, OCIE issued a risk alert regarding Advisers' use of cloud-based storage solutions as it relates to information security and privacy. Firms failed to configure the security settings of their cloud provider, lacked oversight of third-parties who provided such cloud solutions, and did not identify the type of data stored and applicable controls within their policies and procedures.
- On June 5, 2019, the SEC voted to adopt a package of rulemakings and interpretations intended to increase transparency between retail investors and broker-dealers and advisers. This is important for advisers because it finalizes the new Form CRS Relationship Summary. If an adviser has no retail investors to whom to deliver the Form CRS, then it does not need to prepare or file the form. The SEC also issued an interpretation to reaffirm and, in some cases, clarify its views of the fiduciary duty that investment advisers owe to their clients under the Advisers Act. See our article on the interpretation here.
- The SEC hosted numerous outreach seminars during the quarter. Topics ranged from risk-based exam selection and approaches to the latest priorities, including cybersecurity and recidivist violations. Even ESG garnered attention.

## What was the SEC Division of Enforcement up to?

A prominent private fund manager in the mortgage-backed securities space recently agreed to pay $5 million for compliance failures relating to its valuation practices. While the manager had some common violations, what makes this case unique is that assets were undervalued, not overvalued. The SEC emphasized that this manager had been "ranked as one of the top and most consistent performing hedge funds in the country." HighCamp summarized the case and implications here.

**Is that all?** See below for our Q2 Chronological List of Key Events and Upcoming Events & Deadlines.

# Q2 Chronological List of Key Events

Issued: July 8, 2019

*We left off on April 3, 2019 in our First Quarter Compliance Letter for Investment Advisers. You can access it here. For those printing this letter, please note that all sources are hyperlinked rather than footnoted.*

**April 16:** Investment Adviser and Broker-Dealer Compliance Issues Related to Regulation S-P – Privacy Notices and Safeguard Policies

This risk alert issued from OCIE discussed common exam deficiencies related to safeguarding consumer records and information required by the Safeguard Rule.

**April 19:** Silicon Valley Company Settles Fraud Charge for Misstating Returns to Investors

Prosper Funding LLC has settled with the SEC, agreeing to pay a $3 million penalty for miscalculating and materially overstating its returns to retail and other investors. According to the SEC's order, Prosper excluded some "non-performing loans from its calculation of annualized net returns that it reported to investors." Notable is that the SEC made a point to state that they are "committed to holding fintech companies to the same standards applicable to other participants in the securities markets."

**May 3:** SEC Proposes to Improve Disclosures Relating to Acquisitions and Dispositions of Businesses

The SEC proposed amendments to the financial disclosure requirements of Regulation S-X for financial statements of businesses acquired or to be acquired and for business dispositions.

**May 23:** SEC Risk Alert: Safeguarding Customer Records and Information in Network Storage – Use of Third Party Security Features

This risk alert addressed Advisers' use of cloud-based storage solutions and information security and privacy. Firms failed to configure the security settings of their cloud provider, lacked oversight of third-parties who provided cloud solutions, and did not identify the type of data stored and applicable controls within their policies and procedures.

**June 4:** Hedge Fund Adviser to Pay $5 Million for Compliance Failures Related to Valuation of Fund Assets

A prominent private fund manager in the mortgage-backed securities space agreed to pay $5 million for compliance failures relating to its valuation practices. For more, see our summary of the case and its implications here.

**June 4:** Marshall Gandy Named Co-Head of SEC's Investment Adviser/Investment Company Examination Program

Marshall Gandy, the Associate Regional Director for Examinations in the SEC's Fort Worth office, was named Co-National Associate Director of the Investment Adviser/Investment Company examination program in the Office of Compliance Inspections and Examinations (OCIE). In this additional role, he will help oversee more than 630 lawyers, accountants, and examiners responsible for inspections of SEC-registered investment advisers and investment companies.

**June 5:** SEC Adopts Rules and Interpretations to Enhance Protections and Preserve Choice for Retail Investors in Their Relationships with Financial Professionals

This package of rulemakings and interpretations is intended to increase transparency between retail investors and broker-dealers and advisers. The SEC also issued an interpretation to reaffirm and, in some cases, clarify its views of the fiduciary duty that investment advisers owe to their clients under the Advisers Act. See our article on the interpretation here.

**June 18:** SEC Concept Release on Harmonization of Securities Offering Exemptions

This concept release by the SEC summarizes their intention to comprehensively address the current framework for exemption from registration and explore new ways to "simplify, harmonize and improve" regulations surrounding unregistered securities. These regulations also include the accredited investor definition and Regulations D and A. SEC Chairman Jay Clayton has stated his intention to open private markets to ordinary investors "no matter where they are located in the United States."

**June 20:** Walmart Charged with FCPA Violations

Walmart paid more than $282 million to settle SEC charges and criminal charges by the DOJ.

**June 27:** ILPA Releases "Principles 3.0"

This latest edition serves as an update to and expansion of ILPA's 2011 Private Equity Principles publication and provides best practices on industry issues. Principles 3.0 was developed with the input of both LPs and GPs and seeks to inform discussions between these parties in the development of partnership agreements and in the management of funds.

**June 28:** The 2020 GIPS standards have been released

Whether or not your firm seeks to comply with GIPS Standards, they are a valuable resource when benchmarking performance reporting.

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## Upcoming Events & Deadlines

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| July 15 | *Form PF for Large Liquidity Fund Advisers Due* |
| July 30 | *Employees' Personal Q2 Transaction Reports Due* |
| August 29 | *Form PF for Large Hedge Fund Advisers Due* |
| October 15 | *Form PF for Large Liquidity Fund Advisers Due* |

### About HighCamp Compliance

HighCamp Compliance is a premier, boutique compliance consulting and outsourcing firm helmed by former SEC examiners, CCOs, and proven consulting professionals. HighCamp specializes in regulatory compliance and operational support for SEC-registered alternative and institutional investment managers. The team includes specialists in private equity, real estate, and hedge funds.