Simpson Thacher

Regulatory and Enforcement Alert

New SEC Risk Alert Focuses on Investment Adviser MNPI Compliance

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The Division of Examinations (the "Exam Division") of the U.S. Securities and Exchange Commission ("SEC") recently published a Risk Alert (the "Risk Alert")[1] highlighting deficiencies identified during recent examinations of investment advisers concerning compliance issues related to Section 204A of the Investment Advisers Act of 1940 (the "Advisers Act")[2] and Rule 204A-1 thereunder (the "Code of Ethics Rule")[3].

Consistent with the general trend toward a more expansive SEC view of what constitutes material, nonpublic information ("MNPI") as reflected in several recent enforcement actions—certain of which are alluded to but not cited in the Risk Alert—the Risk Alert reflects heightened regulatory expectations with respect to how investment advisers monitor their intake and treatment of MNPI at both the firm and employee level. Given the ever-increasing scrutiny—and, as reflected in recent rulemaking proposals, skepticism—of private fund managers, firms should view this development as another opportunity to ensure that their MNPI-related policies are aligned with how they access the capital markets and reflective of recent developments in insider trading law.

Below is a summary of deficiencies identified in the Risk Alert with the greatest potential impact on advisers' MNPI-related policies.

Alternative Data Providers

Exam Division staff observed advisers that used alternative data but did not adopt or implement reasonably designed written policies and procedures to address the potential receipt and dissemination of MNPI associated with alternative data sources. The Risk Alert specifically referenced deficient diligence processes (including periodic diligence subsequent to on-boarding), as well as failures to memorialize implementation of applicable policies.

Key Takeaways. The Risk Alert's discussion of inadequate diligence of alternative data service providers builds upon the Commission's recent enforcement action in *In the Matter of App Annie Inc.*, which involved settled

[1] Investment Adviser MNPI Compliance Issues, Risk Alert, SEC Division of Examinations (April 26, 2022).

[2] Section 204A requires all investment advisers, registered and unregistered, to establish, maintain, and enforce written policies and procedures that are reasonably designed, taking into consideration the nature of the adviser's business, to prevent the misuse of material non-public information by the adviser or any person associated with the adviser. *See* Section 204A of the Advisers Act.

[3] The Code of Ethics Rule requires registered investment advisers to adopt a code that sets forth, among other things, the standard(s) of business conduct expected from the adviser's "supervised persons" (*e.g.*, employees, officers, partners, directors and other persons who provide advice on behalf of the adviser and are subject to the adviser's supervision and control). *See* Advisers Act Rule 204A-1(a)(1).

fraud charges against an alternative data provider that misrepresented the source of certain of the data it sold to advisers. Although the SEC did not charge the advisers in the *App Annie* case for failing to adequately conduct diligence of the services provided by App Annie, the case signaled heightened SEC focus on the usage of alternative data. The Risk Alert now makes clear the SEC's expectations with respect to advisers who receive alternative data. Advisers should ensure that their policies are consistently implemented across alternative data providers and that their policies address when diligence should be updated. Advisers should take care to timely memorialize the diligence conducted, to avoid a later presumption by the staff that any diligence that was *not* recorded never happened. As a general rule of thumb, vendors offering bespoke or complex data sets that might be related to investment decisions should be subject to rigorous diligence that is periodically updated and documented.

"Value-Add Investors"

The term "value-add investors" generally refers to fund investors (or key persons at institutional investors) who may have access to MNPI by virtue of the nature of their employment, *e.g.,* officers or directors at a public company, principals or portfolio managers at asset management firms, and investment bankers. Exam Division staff observed that advisers did not have or implement adequate policies and procedures addressing the MNPI risks associated with these investors. Exam staff also observed that, even where advisers maintained applicable policies, advisers failed to identify or track relationships with potential sources of MNPI.

Key Takeaways. It is worth noting that the Exam Division, in less detail, recently highlighted deficiencies with respect to "value-add investors" in a June 2020 risk alert. This Risk Alert provides more detail and indicates that advisers should ensure they have policies and procedures in place regarding MNPI risks posed by their "value-add investors," including, as a threshold matter, ensuring that they identify such investors. It is important that such policies are tailored to the adviser's business and operationally achievable. Beyond internal tracking of "value-add investors," firms should ensure—and document—periodic training of investment professionals to ensure they are attuned to the risks associated with MNPI when interacting with "value-add investors," even in ordinary-course settings.

"Expert Networks"

Again, it is worth noting that the Exam Division, in less detail, highlighted deficiencies with respect to expert networks in the June 2020 risk alert. This Risk Alert provides more detail, and the Exam Division staff observed that firms did not have or implement policies regarding discussions with expert network consultants (professionals who are paid for their specialized information and research services) who may be related to publicly traded companies or otherwise have access to MNPI. The Risk Alert noted inadequate tracking of interactions with, and failure to review detailed notes from, expert network consultants. Further, and perhaps most notably, the Risk Alert specifically highlighted policies for "[r]eviewing relevant trading activity of supervised persons in the securities of publicly traded companies ***that are in similar industries*** as those discussed during calls." (emphasis added).

Key Takeaways. Without explicitly acknowledging *SEC v. Panuwat*, an ongoing SEC litigated action featuring a theory of insider trading liability that has been described as "substitute trading," the Risk Alert implies that firms should be taking steps with respect not only to companies that are discussed with expert networks (and thus potentially implicate MNPI about those companies), but also potentially their peer companies and companies in similar industries. This approach presents significant compliance and operational challenges; for example, the phrase "in similar industries" is vague and the Risk Alert offers no practical quantitative or qualitative guidance as to how firms should determine whether MNPI about a particular company also constitutes potential MNPI about other companies. At a minimum, firms should ensure that all access persons receive training on the notion that the securities laws may prohibit trading, while in possession of MNPI about one company, in the securities of other closely correlated companies (*e.g.,* key suppliers, competitors and the like).

Allocation of Investment Opportunities in Connection With Firm and Personal Trading

In connection with its observations with respect to Code of Ethics deficiencies, the Exam Division staff stated that "advisers should consider incorporating procedures to ensure that investment opportunities must first be offered to clients before the adviser or its employees may act on them." The Risk Alert notes that the staff observed situations where the adviser or its employees purchased securities at a better price before the adviser's clients in contravention of the adviser's code.

Key Takeaways. This observation concerns potential breaches of fiduciary duty or potentially fraud (*e.g.*, front running) rather than MNPI-related concerns. Moreover, while this observation likely arose from examinations of principally retail-facing advisers, it is a reminder that compliance personnel must be vigilant when preclearing employee trades that involve strategies or securities that may relate to existing investor or fund strategies.

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