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SEC Highlights Investment Adviser MNPI Compliance Issues

On April 26, 2022, the SEC's Division of Examinations ("EXAMS") published a Risk Alert (available [here](#)) highlighting deficiencies observed by staff in their examinations of investment advisers associated with their policies, procedures and controls around the creation, receipt and use of potential material non-public information ("MNPI"). Section 204A of the Investment Advisers Act of 1940 (the "Advisers Act") 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 MNPI by the adviser or any person associated with the adviser. Rule 204A-1 thereunder (the "Code of Ethics Rule") requires investment advisers that are registered or required to be registered under the Advisers Act to adopt a code of ethics that, among other things, includes standards of business conduct and requires certain personnel of an investment adviser to report, and the adviser to review, their personal securities transactions and holdings periodically and to obtain pre-approval of certain investments. Deficiencies related to Section 204A and the Code of Ethics Rule have been among the deficiencies most commonly observed by EXAMS.

Key Takeaways

Recent enforcement activity confirms that the SEC is prepared to bring enforcement actions against investment advisers for alleged failures to maintain policies and procedures reasonably designed to prevent the misuse of MNPI – even where the SEC does not allege that there was any actual insider trading. Although the Risk Alert identifies several categories of potential MNPI that may warrant additional scrutiny (including information associated with "expert networks," "value-add investors" and "alternative data"), investment advisers should be reminded to consider carefully the particular MNPI risks presented by "the nature of such investment adviser's business" to ensure that policies and procedures are tailored to address those risks. Finally, the Risk Alert should serve as a further reminder of the importance of adhering consistently to policies and procedures and maintaining appropriate documentation to demonstrate compliance with such policies and procedures.

Policies and Procedures Relating to MNPI

EXAMS observed the following deficiencies associated with policies, procedures and controls around MNPI:

- **Expert Networks** – Failure to implement adequate policies and procedures regarding an investment adviser's discussions with "expert network" consultants who may be related to publicly traded companies or have access to MNPI, including: (1) tracking and logging calls with expert network consultants; (2) reviewing detailed notes from expert network calls; and (3) reviewing relevant trading activity of supervised persons in the securities of publicly traded companies that are in similar industries as those discussed during calls with experts.
- **Value-Add Investors** – Failure to implement adequate policies and procedures regarding investors or key persons who are more likely to possess MNPI, including officers or directors of a public company, principals or portfolio managers at asset management firms and investment bankers; failure to adopt policies and procedures regarding MNPI risks posed by such "value-add investors"; and policies and procedures that failed to correctly identify all of the value-add investors or to correctly identify and track their relationships with potential sources of MNPI.

- **Alternative Data** – Failure to adopt or implement reasonably designed written policies and procedures to address the potential risk of receipt and use of MNPI through non-traditional or “alternative data” sources (e.g., satellite and drone imagery and photography, analyses of aggregate credit card transactions, social media and internet search data, geolocation data from consumers’ mobile phones, and email data obtained from apps and tools that consumers may utilize), including: (1) failure to adequately memorialize or consistently follow diligence processes with respect to alternative data service providers; (2) failure to adopt policies and procedures regarding the assessment of the terms, conditions or legal obligations related to the collection or provision of the data, including when the investment adviser became aware of red flags about the sources of such alternative data; and (3) failure to consistently implement policies and procedures related to alternative data service providers (e.g., failure to apply the investment adviser’s due diligence process to all sources of alternative data; inadequate procedures for determining when due diligence needed to be re-performed on alternative data service providers based on passage of time or changes in data collection practices; and inability to demonstrate, such as by producing documentation, that the investment adviser’s policies and procedures had been consistently implemented).

Code of Ethics

The Code of Ethics Rule requires investment advisers that are registered or required to be registered under the Advisers Act to adopt a code of ethics 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). The Code of Ethics Rule also requires “access persons” (any supervised persons who have access to non-public information regarding client transactions or reportable fund holdings, make securities recommendations to clients or have access to such recommendations that are non-public) to report their personal securities transactions and holdings to the adviser’s chief compliance officer (“CCO”) or other designated person(s).

EXAMS observed the following deficiencies associated with the Code of Ethics Rule:

- **Identification of Access Persons** – Failure to identify and supervise certain employees as access persons in accordance with the Code of Ethics Rule and codes that failed to define “access person” or accurately reflect which employees are considered access persons.
- **Pre-Approval for Certain Investments** – Failure by access persons to obtain the requisite pre-approval before purchasing direct or indirect ownership in initial public offerings and limited offerings and codes that failed to include such requirements.
- **Personal Securities Transactions and Holdings** – Failures associated with the required reporting of access persons’ personal securities transactions and holdings, including: (1) inadequate evidence of supervisory review of holdings and transaction reports; (2) failure to have policies and procedures in place to assign the CCO’s reporting to another officer or member of the investment adviser; (3) failures by access persons to submit the holdings and/or transaction reports; (4) codes that did not require access persons to submit the reports; (5) failures to submit reports in a timely manner; and (6) codes that did not require access persons to include the specified content set out by the Code of Ethics Rule in their transaction and holdings reports, including investments in private placements.
- **Written Acknowledgement of Receipt of Code** – Failure to provide supervised persons with a copy of the code; failure by supervised persons to provide written acknowledgement of their receipt of the code or any amendments and codes that did not contain provisions to reflect the written acknowledgment requirement of Rule 204A-1(a)(5).
- **Trading Investments on Restricted List** – Employees that traded investments on the investment adviser’s “restricted list.”
- **Allocation of Investment Opportunities** – Failure to follow policies and procedures regarding the allocation of investment opportunities (e.g., where the investment adviser or its employees purchased securities at a better price, ahead of the adviser’s clients in contravention of the adviser’s code).

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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