SIDLEY

SIDLEY UPDATE

2020 Update for Investment Advisers Important Annual Requirements; 2020 SEC Exam Priorities; Recent SEC Enforcement Initiatives

March 6, 2020

Investment advisers registered with the Securities and Exchange Commission (the "SEC") (each, an "RIA") are subject to certain annual requirements under the Investment Advisers Act of 1940 (the "Advisers Act"); some of these requirements also either apply to exempt reporting advisers (each, an "ERA") or warrant consideration as best practices for ERAs. This Sidley Update alerts investment advisers to certain annual regulatory and compliance obligations, including a number of significant 2020 reporting or filing deadlines.

This Sidley Update also reminds advisers that are registered as commodity pool operators ("CPOs") or commodity trading advisors ("CTAs") with the Commodity Futures Trading Commission (the "CFTC") and members of the National Futures Association (the "NFA") of certain CFTC and NFA reporting requirements.

This Sidley Update provides important information regarding

- **Annual Form ADV Updating Requirements (page 2)**
- **Compliance Program Review and Testing (page 4)**
- **Other Annual Reminders for RIAs and ERAs (page 6)**
- **SEC Examination Priorities for 2020 (page 8)**
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This Sidley Update does not purport to be a comprehensive summary of all of the compliance obligations to which advisers are subject; please contact your Sidley lawyer to discuss these and other requirements under the Advisers Act, the Commodity Exchange Act and other regulations that may be applicable to investment advisers, CPOs and/or CTAs.[1]

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[1] This Sidley Update generally does not address non-U.S. regulatory developments, a number of which are covered in other Sidley Updates. For example:

- The UK withdrew from the European Union (EU) on January 31, 2020 under the terms of an amended withdrawal agreement between the UK government and the leaders of the European Council. See Sidley Austin LLP, Sidley Update, "Brexit Implementation Period and Beyond: Key Points for the Payments Sector" (January 28, 2020), https://www.sidley.com/en/insights/newsupdates/2020/01/brexit-implementation-period-and-beyond_key-points-for-the-payments-sector.
- In December 2019, the EU's Investment Firms Directive (IFD) and Investment Firms Regulation (IFR) was published. The new IFR/IFD prudential framework is expected to come into effect in Q4 2020 or Q1 2021.

Form ADV Annual Updating Amendment for RIAs; Brochure Delivery to Clients

Annual Updating Amendment

Each RIA must file an annual updating amendment to its Form ADV within 90 days of its fiscal year end. Accordingly, an RIA with a December 31, 2019, fiscal year end must file its annual amendment by March 30, 2020. Part 1A and Part 2A (the adviser's "brochure") are filed electronically with the SEC via the Investment Adviser Registration Depository ("IARD") and are publicly available. Part 2B, the brochure supplement, is not required to be filed with the SEC but must be preserved by the adviser and made available, if requested, to the SEC for examination.

IARD will not accept an annual Form ADV updating amendment without (i) an updated Part 2A brochure, (ii) a representation by the adviser that the brochure on file does not contain any materially inaccurate information or (iii) a representation that the adviser is not required to prepare a brochure because it is not required to deliver it to any clients. In addition, IARD collects annual fees associated with Form ADV filings. IARD cannot accept a filing until the fees are paid and posted to the adviser's account. An adviser should ensure that proper funding is set up electronically prior to filing its annual amendment and allow sufficient time for fee processing and posting.

An RIA must update its Form ADV Part 1A more frequently if required, as specified in General Instruction 4 to Form ADV[2] by filing an other-than-annual amendment. The RIA also must update (and file) its Part 2A brochure promptly when any information in the brochure becomes materially inaccurate.

Annual Delivery of Brochure to Clients

Within 120 days of its fiscal year end, an RIA must deliver to each client for which delivery is required either:

- Its updated Part 2A brochure and a summary of material changes to the brochure, if any; or
- A summary of material changes, if any, accompanied by an offer to provide the updated brochure, which, if requested, must be mailed within seven days or delivered electronically in accordance with SEC guidelines.

The brochure is required to be delivered to "clients," which the SEC staff has acknowledged does not include fund investors. However, many fund advisers voluntarily deliver the brochure to fund investors. An RIA with a December 31, 2019, fiscal year end must deliver its updated brochure to clients by April 29,

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See Sidley Austin LLP, Sidley Update, "New EU Investment Firm Prudential (Capital and Remuneration) Regime – Analysis of Final Text" (April 23, 2019), https://www.sidley.com/en/insights/newsupdates/2019/04/new-eu-investment-firm-prudential-regime.

- In June 2019, the EU introduced certain changes to the scope of EMIR through the EMIR REFIT legislation. See Sidley Austin LLP, Sidley Update, "EMIR REFIT: Impact on Asset Managers" (March 13, 2019), https://www.sidley.com/en/insights/newsupdates/2019/03/emir-refit-impact-on-asset-managers.
- In April 2019, the European Parliament voted to adopt a new legislative package relating to the cross-border distribution of collective investment funds in the EU, including amendments to the Alternative Investment Fund Managers Directive (AIFMD). The new rules will apply from August 2021. See Sidley Austin LLP, Sidley Update, "EU AIFMD: New Rules on Pre-Marketing and Reverse Solicitation" (May 21, 2019), https://www.sidley.com/en/insights/newsupdates/2019/05/eu-aifmd-new-rules-on-pre-marketing-and-reverse-solicitation.
- Entities within the asset management sector that conduct regulated activities or trade securities in Hong Kong were affected by various regulatory and enforcement developments. See Sidley Austin LLP, Sidley Update, Asia Funds & Financial Services Newsletter (February 2020), https://www.sidley.com/en/insights/newsupdates/2020/02/asia-funds-and-financial-services-newsletter for a summary of some of those developments.

[2] Form ADV: General Instructions, http://www.sec.gov/about/forms/formadv-instructions.pdf.

2020.[3]

Importance of Accurate and Complete Form ADV Disclosure

Inaccurate, misleading or omitted Form ADV disclosure is a frequently cited deficiency in SEC examinations and has been the basis of a number of enforcement proceedings. More technically, Form ADV and Form PF are linked electronically, and inconsistencies in disclosure in the two forms can raise red flags in connection with an SEC examination and prevent an adviser from successfully filing Form PF.

Disclosure points of particular importance include:

- An adviser must accurately calculate its regulatory assets under management ("RAUM"). RAUM must be calculated on a gross basis, including proceeds of leverage and uncalled capital commitments and without deduction of any outstanding indebtedness or other accrued but unpaid liabilities, according to specific instructions provided in Instruction 5.b of Form ADV: Instructions for Part 1A (Part 1A Instructions).[4]
- An adviser to private funds (i.e., funds that rely on the exclusion from the definition of investment company provided by Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (the "1940 Act")) must provide specific information regarding those funds on Form ADV. Correct classification of the funds advised, according to the specific definitions provided in Instruction 6 of the Part 1A Instructions, is necessary to determine an adviser's Form PF filing category (see Form PF Reporting Requirements — Determining an Adviser's Filing Category below).
- An adviser that has added a new private fund as a client since its last Form ADV annual updating (or other) amendment may need to amend Form ADV to add the new fund before information regarding the new fund can be reported on Form PF. An adviser in this situation may need to file its annual Form ADV amendment early or file an other-than-annual amendment in order to timely file Form PF.[5]

Form ADV Annual Updating Amendment for ERAs

Advisers relying on the "private fund adviser" exemption or the "venture capital fund adviser" exemption from SEC registration are ERAs and are required to file reports on Form ADV Part 1A with the SEC through IARD. An ERA, like an RIA, must amend its Form ADV at least annually, within 90 days of its fiscal year end, and more frequently if required, as specified in General Instruction 4 to Form ADV. Hence, an ERA with a December 31, 2019, fiscal year end must file its annual updating amendment by March 30, 2020.

An ERA relying on the private fund adviser exemption must calculate annually the private fund RAUM that it manages and report the amount in its annual Form ADV amendment. If a U.S.-based ERA reports in its annual amendment that it has US$150 million or more of private fund RAUM or has accepted a client that is not a private fund, the adviser is no longer eligible for the private fund adviser exemption.[6] A private fund

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[3] In a two-part netcast on September 12, 2018, the SEC staff noted that certain advisers have claimed to deliver their brochures to clients by posting a link on their websites without taking any further steps to ensure delivery. This practice, the staff reminded advisers, is not sufficient for purposes of complying with Rule 204-3 (the "brochure delivery rule").

[4] Form ADV: Instructions for Part 1A, https://www.sec.gov/about/forms/formadv-instructions.pdf.

[5] See Form PF: General Instructions, https://www.sec.gov/files/formpf.pdf. A private fund must have an identification number for both Form ADV and Form PF reporting. The instructions state, "If you need to obtain a private fund identification number [obtained by filing Form ADV] and you are required to file a quarterly update of Form PF prior to your next annual update of Form ADV, then you must acquire the identification number by filing an other-than-annual amendment to your Form ADV …. [and] must complete and file all of Form ADV Section 7.B.1 for the new private fund."

[6] An ERA based outside of the United States will lose the exemption if it (i) manages private fund assets of US$150 million or more at a place of business in the United States; (ii) advises a U.S. client other than a private fund (e.g., a managed account for a U.S. institution or pension plan); or (iii) manages any non-private-fund assets at a place of business in the United States. For purposes of this exemption, a single investor fund or "fund of one" generally will be deemed to be a managed account.

adviser that has complied with all ERA reporting requirements but is no longer eligible for the private fund adviser exemption because its RAUM meets or exceeds US$150 million must apply for registration with the SEC within 90 days after filing the annual amendment and may continue advising private fund clients during this period. This transition period is not available to an adviser that otherwise would not qualify for the private fund adviser exemption, such as an adviser that accepts a separately managed account. Rather, an adviser relying on this exemption must be registered with the SEC (or, if pertinent, with one or more states) prior to accepting a non-private-fund client. The transition period also is not available to advisers relying on the venture capital fund adviser exemption; such an adviser (whether based in or outside of the United States) must register under the Advisers Act before accepting a client that is not a venture capital fund unless the adviser is eligible for another exemption from registration.

Annual Compliance Program Review

Rule 206(4)-7 under the Advisers Act (the "Compliance Rule") requires an RIA to designate a Chief Compliance Officer ("CCO") and adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder by the adviser and its supervised persons. The Compliance Rule does not enumerate specific elements that must be included in the compliance policies and procedures.[7] Rather, the SEC staff has indicated that it expects an RIA's policies and procedures to be based on an assessment of the regulatory and compliance risks present in the adviser's business that may result in violations of the Advisers Act (a "risk assessment") and a determination of controls needed to manage or mitigate these risks.

Common Deficiencies in Compliance Programs

A Risk Alert[8] issued by the SEC's Office of Compliance Inspections and Examinations ("OCIE") described examples of deficiencies or weaknesses in connection with the Compliance Rule frequently identified in OCIE examinations. Examples include:

- *Compliance manuals are not reasonably tailored to the adviser's business practices*. The staff noted that certain compliance programs did not take into account important individualized business practices, such as the adviser's particular investment strategies, types of clients, trading practices, valuation procedures and advisory fees.
- *Annual review was not performed or did not address the adequacy of the adviser's policies and procedures.* The staff also observed that some advisers did not address or correct problems identified in their annual reviews.
- *Adviser does not follow its compliance policies and procedures.*
- *Compliance manuals are not current*. The staff noted that certain compliance manuals contained information or policies that are no longer current.

The staff of the SEC's New York Regional Office (the "NYRO staff") has noted[9] specific examples of certain deficiency types, including these:

- *Policies and procedures that are incomplete or inaccurate.* The staff cited as an example valuation policies that did not reflect certain practices followed by an adviser in connection with fair valuation, highlighting the need for the adviser's compliance staff ("Compliance") to know what the business and back office staff are doing in practice, not just on paper.

[7] In the adopting release for Rule 206(4)-7, "Compliance Programs of Investment Companies and Investment Advisers," IA-2204 (December 17, 2003), the SEC staff stated that an adviser's policies and procedures, at a minimum, should address the following issues to the extent they are relevant: portfolio management processes; trading practices; proprietary and personal trading; accuracy of disclosures; safeguarding of client assets; recordkeeping; marketing advisory services; valuation; privacy; and business continuity plans.
[8] SEC National Exam Program Risk Alert, "The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers" (February 7, 2017), https://www.sec.gov/ocie/Article/risk-alert-5-most-frequent-ia-compliance-topics.pdf.
[9] See Note 3 above.

- *Policies and procedures that are not modified in light of new business practices, products or clients*. The staff stated that Compliance should be involved at the beginning of discussions about new business lines or products, as these proposals may require changes not only to policies and procedures but also to staffing levels or expertise, compliance monitoring or testing, Form ADV and other disclosure documents and the annual compliance review.
- *Policies and procedures that are not adequately documented*. The staff offered the example of an adviser using quantitative models for investment decisions but failing to establish written policies and procedures surrounding the review and approval of those models to ensure that the models were operating effectively and as intended.

Periodic and Annual Review

The Compliance Rule also requires an RIA to review at least annually the adequacy of its policies and procedures and the effectiveness of their implementation. The required annual review may be conducted in stages throughout the year or all at once, depending on what works best for the adviser. The SEC staff has stated that an RIA's compliance program should continue to evolve in conjunction with an ongoing risk assessment (and re-evaluation) process.

The annual review should include consideration of any developments during the year that might suggest a need to revise the adviser's compliance program (if not already addressed), including, among other things:

- Results of any SEC examinations of the adviser;
- Review of material compliance matters that arose;
- Changes in the adviser's business activities or operations (e.g., entering a new line of business);
- Recent enforcement actions; and
- Changes to applicable laws, rules, regulations and/or SEC staff guidance.

The review process should incorporate reasonable trend analysis and "macro" analysis as well as "transactional" (i.e., spot) tests to detect gaps in the compliance program or instances in which the adviser's policies and procedures may have been circumvented or are not operating effectively. OCIE recommends that the adviser document the content, timing and results of the testing, which can expedite the staff's review of the adviser's compliance program when the adviser is examined.[10] Any issues identified in the testing process should be accompanied by a strategy for remediation and the results of any remediation efforts.

The adviser should document the annual review as well as steps taken to revise or enhance the compliance program to reflect the results of the review. Upon examination, the SEC will require the adviser to produce documentation evidencing the required annual review. Failure by an RIA to conduct a timely annual review is an often-cited violation in addition to other charges brought by the SEC's Division of Enforcement.

Report to Management

As a best practice, an RIA's senior management, at least annually, should convene a special meeting to review the effectiveness of the adviser's compliance policies and procedures. A formal written report summarizing the conclusions of senior management should be filed in the adviser's compliance records, together with a memorandum summarizing the responses, if any, made to perceived deficiencies or inadequacies as well as evaluating the approach taken to any specific compliance problems during the year. Senior management should be engaged as frequently as necessary during the year to assist in establishing and maintaining a culture of compliance within an adviser's organization.

Training and Annual Certification

The SEC staff emphasizes the importance of advisers educating their supervised persons concerning the

[10] See Note 3 above.

general principles as well as the specific requirements of the adviser's compliance program. Pertinent training should take place on at least an annual basis and more frequently as convenient or necessary, such as when an employee joins the firm or when the testing of policies and procedures demonstrates a lack of understanding of the policies and procedures.

An RIA's compliance policies and procedures should be documented in a compliance manual distributed to all supervised persons. All supervised persons should be required to execute and deliver, at least annually, a certificate stating that they have read (or re-read) and understand the provisions in the compliance manual (including any revisions or updates), including the code of ethics and the adviser's policies and procedures designed to detect and prevent insider trading. Many firms also use an annual certification to remind supervised persons of their specific disclosure obligations, such as the obligation to disclose outside business activities.

ERAs

An ERA, as an unregistered adviser, is not required to adopt a comprehensive compliance program pursuant to the Compliance Rule or to comply with most other rules under the Advisers Act. Unregistered advisers, however, are still subject to the Advisers Act's antifraud provisions. An ERA, therefore, should adopt reasonable compliance policies, procedures and oversight to avoid even the appearance of a violation of the antifraud provisions or the ERA's fiduciary duty to clients. Like an RIA, an ERA is subject to Advisers Act Rule 206(4)-5 (the "Pay-to-Play Rule") as well as the Advisers Act requirement that an adviser adopt policies and procedures reasonably designed to prevent insider trading. As a best practice, an ERA should review at least annually the adequacy of its policies and procedures and make any needed revisions.

Advisers Registered as CPOs and/or CTAs — NFA Self-Examination and Attestation

NFA believes that all NFA members should regularly review the adequacy of their supervisory procedures. To satisfy their continuing supervisory responsibilities, NFA members must review their operations yearly using NFA's Self-Examination Questionnaire, which includes a general questionnaire that must be completed by all NFA members and supplemental questionnaires (i.e., CPO and CTA) that must be completed as applicable.

After reviewing the annual questionnaires, an appropriate supervisory person must sign and date a written attestation stating that he or she has reviewed the NFA member's operations in light of the matters covered by the questionnaire. A separate attestation must be made for each branch office, and if the branch office reviews its own operations, the main office must receive a copy of the questionnaire's signed attestation. A branch office is an office of the NFA member other than the main office, not a separate entity affiliated with the NFA member. These attestations should be readily available for the most recent two years and retained for the most recent five years.

Other Annual Reminders for RIAs and ERAs

Other annual obligations, as pertinent, include the following (nonexclusive list):

Review of Disclosure and Offering Documents. An adviser should review all disclosure documents (including fund offering materials) at least annually to ensure that content and disclosure are accurate, up to date and consistent across documents (including filings with the SEC and other regulators) and with the adviser's compliance policies and procedures. Advertising materials, pitch books, standard due diligence questionnaire responses and the adviser's website should also be reviewed.

Annual Personal Securities Holdings Report. On an annual basis, an RIA must collect from each "access person" (by a date specified by the adviser) an annual personal securities holding report containing certain required information regarding securities holdings and all securities accounts. The information must be current as of a date no more than 45 days prior to the date the report is submitted.

Annual Delivery of Privacy Notice. An adviser must provide clients and fund investors who are natural persons with a privacy notice disclosing the adviser's practices for maintaining privacy of nonpublic personal information, both at or before the establishment of the customer relationship and annually thereafter. This privacy notice should provide clients and fund investors with the right to "opt out" from the sharing of nonpublic personal information with unaffiliated third parties, if applicable. An adviser is not required to make an annual distribution of its privacy notice if the adviser (a) only provides nonpublic personal information to unaffiliated third parties for limited, non-marketing-related purposes and (b) has not changed its policies and practices from those disclosed in the adviser's most recent privacy notice provided to clients and fund investors.

Annual "Bad Actor" Recertification. Private funds and other issuers are not permitted to rely on the exemption from Securities Act of 1933 (the "Securities Act") registration provided by Rule 506 of Regulation D if the pertinent offering involves certain "bad actors." For continuous or other offerings of long duration, an adviser must update, with reasonable care, its factual inquiries (i.e., by email or questionnaire) to determine whether any covered persons have "disqualifying events," which may also require disclosure in Form ADV.

Annual Eligibility for "New Issues." An adviser should verify annually the eligibility of clients and fund investors to participate in new issues of publicly offered securities (i.e., initial public offerings) to make sure "restricted persons" are properly identified and their participation is appropriately restricted.

On December 19, 2019, the Financial Industry Regulatory Authority ("FINRA") published Regulatory Notice 19-37, announcing amendments to FINRA Rules 5130 and 5131 relating to new issues of publicly offered securities (i.e., initial public offerings). The amendments took effect on January 1, 2020 and, among other things, expanded the categories of investors that are unrestricted from holding "new issues" under FINRA Rules 5130 and 5131. If an RIA has a "new issues" questionnaire in its fund subscription documents, the RIA should revise such questionnaire to reflect the rule amendments and then distribute the revised questionnaire as part of its annual "new issues" eligibility verification.

Form D and "Blue Sky" Filings. Form D filings for private funds with ongoing offerings lasting longer than one year must be amended annually, on or before the first anniversary of the initial Form D filing. On an annual basis, an adviser also should review blue sky filings for each state to ensure that any renewal requirements are met. The NYRO staff indicated in 2018 that examiners had noticed an increase in the number of Form D deficiencies, such as missing or late filings, forms not completed according to the instructions and inconsistencies between Form D and Form ADV.[11]

Distribution of Audited Financials to Private Fund Investors. An adviser relying on the "audit provision" of Advisers Act Rule 206(4)-2 (the "Custody Rule") with respect to its private fund clients must deliver audited financial statements of each pertinent private fund to fund investors within 120 days of the fund's fiscal year end (by April 29, 2020, if the fiscal year ends on December 31) or within 180 days of the private fund's fiscal year end, if the private fund is a fund of funds (by June 28, 2020, if the fiscal year ends on December 31).

Annual Affirmation of CFTC Exemptions. Advisers claiming an exemption from registration under CFTC Rules 4.13(a)(1), 4.13(a)(2), 4.13(a)(3) or 4.13(a)(5) or exclusion from the definition of CPO under Regulation 4.5, and CTAs claiming an exemption from CTA registration under Regulation 4.14(a)(8), must affirm the applicable notice of exemption or exclusion within 60 days of each calendar year end — March 2, 2020 — or be deemed to have requested a withdrawal of the applicable exemption or exclusion.

Confirming Affirmation of Investors/Clients Claiming Exemptions Under CFTC Rules. In a January 15, 2020 Notice to Members, NFA noted that persons claiming an exemption from CPO registration under CFTC Rule 4.13(a), an exclusion from CPO registration under CFTC Rule 4.5 or an exemption from CTA registration under CFTC Rule 4.14(a)(8) have until March 2, 2020 to file their annual affirmation of the exemption and that, therefore, it may be difficult for an NFA member to determine whether a CPO or CTA

[11] See Note 3 above.

that previously claimed an exemption continues to be eligible for the exemption. Accordingly, NFA indicated that a registered CPO or CTA that takes reasonable steps to determine the registration and membership status of investors/clients claiming an exemption or exclusion under these CFTC rules will not be in violation of NFA Bylaw 1101 or Compliance Rule 2-36(d) if between January 1 and April 1, 2020 it transacts customer business with a previously exempt person that fails to (a) become registered and a member of NFA, (b) file a notice affirming its exemption from CPO/CTA registration or (c) provide a written representation as to why the person is not required to register or file the notice affirming the exemption.[12]

BEA and TIC Reporting Requirements for Cross-Border Investments. Investment advisers and other financial institutions may be required to file reports with the Bureau of Economic Analysis ("BEA") for surveys of cross-border "direct investments" (generally, voting interests of 10 percent or more) by or in U.S. entities, among other things,[13] and with the Treasury Department, for Treasury International Capital ("TIC") surveys of cross-border "portfolio investments" (generally, nonvoting interests and voting interests of less than 10 percent).[14]

Firms should routinely review the reporting requirements and applicable thresholds and exemptions to determine whether and when they must proactively file reports or claims for exemption with the BEA or the Treasury Department. In addition, firms may be required to submit reports for certain surveys, even if filing thresholds have not been met or exceeded, if contacted by the BEA or the Treasury Department.

SEC Examination Priorities for 2020

On January 7, 2019, OCIE published its examination priorities for 2020 (the "Exam Priorities") for various regulated entities, including investment advisers.[15] OCIE announces its exam priorities annually to provide insights into the areas it believes present potentially heightened risk to investors or the integrity of the U.S. capital markets.[16] The Exam Priorities can serve as a roadmap to assist advisers in assessing their policies, procedures and compliance programs; testing for and remediating any suspected deficiencies related to the Exam Priorities; and preparing for OCIE exams. Advisers are encouraged to review their current policies, procedures and client disclosures with these priorities in mind. ERAs, as well as RIAs, are subject to SEC examination, although the SEC has indicated that it does not expect to examine ERAs on a routine basis.

OCIE completed 3,089 examinations, including approximately 2,180 RIA examinations, in FY 2019. While this is a 2.7 percent decrease from FY 2018, OCIE attributes the decrease (which is relatively small) to the month-long suspension of examinations during the 2019 government shutdown. In FY 2019, the OCIE National Exam Program examined approximately 15 percent of all RIAs. OCIE has increased its examination coverage of RIAs over the past several years from 10 percent in FY 2014 to a high of 17 percent in FY 2018.

OCIE's current examination priorities, as outlined in the 2020 Exam Priorities Report, reflect both perennial risk areas that have been emphasized in recent years and risks associated with developing products and services. The priorities are organized around seven themes: (a) retail investors, including seniors and those saving for retirement; (b) information security, including cybersecurity risks; (c) financial technology and

[12] NFA Notice I-20-02, "Member obligations under NFA Bylaw 1101 and Compliance Rule 2-36(d) with respect to CPOs/CTAs exempt from registration" (January 15, 2020), https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=5192.
[13] These include both surveys of foreign direct investment in the United States such as BE-13, BE-605, BE-12 and BE-15 and surveys of U.S. direct investment abroad such as BE-577, BE-10 and BE-11.
[14] These TIC surveys include the TIC Form S, the TIC Form SLT, the TIC Form SHC and the TIC Form SHL.
[15] SEC Office of Compliance Inspections and Examinations, "2020 Examination Priorities" (January 7, 2020), https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2020.pdf (the "2020 Exam Priorities Report"). See also Sidley Austin LLP, Sidley Update, "SEC and FINRA Issue 2020 Examination Priorities for Broker-Dealers and Investment Advisers (January 17, 2020), https://www.sidley.com/en/insights/newsupdates/2020/01/sec-and-finra-issue-2020-examination-priorities-for-broker-dealers-and-investment-advisers.
[16] SEC Press Release 2020-4, "SEC Office of Compliance Inspections and Examinations Announces 2020 Examination Priorities" (January 7, 2020), https://www.sec.gov/news/press-release/2020-4.

innovation, including digital assets and electronic investment advice; (d) focus areas involving RIAs, investment companies, broker-dealers and municipal advisors; (e) anti-money laundering programs of financial institutions that are required by regulation to establish such programs; (g) market infrastructure; and (h) select areas and programs of FINRA and the Municipal Securities Rulemaking Board.[17]

Exams are Risk-Based and Data-Driven

OCIE notes in the 2020 Exam Priorities Report that, while the Exam Priorities provide a preview of key drivers of OCIE examinations where OCIE intends to focus its limited resources, they do not encompass all of the areas that will be covered in exams. As explained in the 2020 Exam Priorities Report, the scope of any examination is determined through a risk-based approach that includes analysis of the registrant's operations, products offered and other factors. The 2020 Exam Priorities Report emphasizes that this risk-based approach, both in selecting registered entities to examine and determining the scope of risk areas to examine, "provides OCIE with greater flexibility to cover emerging and exigent risks to investors and the marketplace as they arise."

Continued Focus on Retail Investors

For both broker-dealers and investment advisers, OCIE continues to emphasize the protection of retail investors. Examinations will have a particular focus on (a) seniors, including recommendations and advice made by advisers targeting retirement communities, and on teachers and military personnel and (b) retail-targeted investments, such as mutual funds and exchange-traded funds ("ETFs"), municipal securities, other fixed income securities and microcap securities. Among other focus areas, examiners will look for financial incentives that may influence the selection of particular mutual fund share classes; will seek to ensure that investors are receiving fee discounts consistent with applicable requirements; and will review the oversight practices of fund boards of directors.

Other Focus Areas Relevant to Investment Advisers

Many of the topics covered in the Exam Priorities, including those discussed primarily in the section on retail investors, are relevant not only to advisers with retail clients but also to advisers that advise other types of clients, including institutional clients and private funds. Focus areas include:

Disclosure, Conflicts of Interest, Fiduciary Duty. OCIE will continue to examine RIAs to evaluate whether, as fiduciaries, they have fulfilled their duties of care and loyalty. This will include assessing whether RIAs provide advice in the best interests of their clients and eliminate, or at least expose through full and fair disclosure, all conflicts of interest that might incline an RIA, consciously or unconsciously, to render advice that is not disinterested. Among other things, OCIE will review for firms' compliance with the Interpretation Regarding Standard of Conduct for Investment Advisers that was issued in June 2019, as well as the content and delivery of the new Form CRS Relationship Summary.

RIAs to Private Funds. OCIE will continue to focus on RIAs to private funds that have a greater impact on retail investors, such as firms that provide management to separately managed accounts side-by-side with private funds. OCIE also will assess compliance risks, including controls to prevent the misuse of material, non-public information, and conflicts of interest, such as undisclosed or inadequately disclosed fees and expenses and the use of affiliates to provide services to clients.

Higher Risk Products. OCIE will focus on higher risk products – including private placements and securities of issuers in new and emerging risk areas – such as those that are complex or non-transparent and/or have high fees and expenses, or where an issuer is affiliated with the firm making the recommendation.

RIA Compliance Programs. Areas of focus will include whether firms maintain effective compliance programs to address the risks associated with best execution and prohibited transactions. OCIE will

[17] See Note 15 above.

prioritize examining firms that utilize the services of third-party asset managers to assess, among other things, the adequacy of due diligence practices. The 2020 Exam Priorities Report noted that OCIE has a particular interest in the adequacy of disclosures provided by RIAs offering new or emerging investment strategies, such as strategies which incorporate environmental, social and governance (ESG) criteria. OCIE also prioritizes examination for compliance with the Advisers Act custody rule, including audited financial statements and surprise examinations.

Never-Before-Examined Investment Advisers. OCIE will continue to conduct risk-based examinations of certain investment advisers that have never been examined, including newly-registered advisers as well as advisers registered for several years that have not yet been examined. OCIE also will prioritize examinations of certain investment advisers that have not been examined for a number of years to focus on whether the firms' compliance programs have been appropriately adapted in light of any substantial growth or change in their business models.

Dual Registrants. OCIE will continue to prioritize examinations of RIAs that are dually registered as, or are affiliated with, broker-dealers, or have supervised persons who are registered representatives of unaffiliated broker-dealers.

Information Security (including Cybersecurity). OCIE will continue to work with firms to identify and address information security (including cyber-related) risks. Specific to RIAs, OCIE will continue to focus its exams on assessing protection of clients' personal financial information. Particular focus areas will include (1) governance and risk management; (2) access controls; (3) data loss prevention; (4) vendor management (including oversight practices related to network solutions and cloud-based storage); (5) training; and (6) incident response and resiliency.

Digital Assets. In light of the perceived heightened risks of digital products, OCIE will continue to focus on market participants in the digital assets market. OCIE examinations related to digital assets will assess portfolio management and trading practices, safety of client funds and assets, pricing and valuation and effectiveness of compliance programs and controls. OCIE examinations related to digital assets also will assess investment suitability and supervision of employee outside business activities.

Robo-Advisers. Examinations of RIAs that provide services to clients through automated investment tools and platforms (often referred to as "robo-advisers") will focus on areas including SEC registration eligibility; cybersecurity policies and procedures; marketing practices; adherence to fiduciary duty, including adequacy of disclosures; and effectiveness of compliance programs.

Preparing for an SEC Examination

It is critically important that advisers be prepared for the possibility of an exam, including possibly on short notice.

OCIE's Pre-Examination Evaluation

While OCIE generally follows a risk-based examination strategy, an adviser may be selected for examination for any number of reasons including, but not limited to, the adviser's risk profile; a tip, complaint or referral; or OCIE's review of a particular compliance risk area. Certain advisers also are selected randomly. Examiners typically will not share with the adviser the reason that the entity has been selected for examination.[18]

According to a December 2019 SEC staff report,[19] before a private fund adviser examination begins, the

[18] SEC Office of Compliance Inspections and Examinations, "Examination Information for Entities Subject to Examination or Inspection by the Commission," https://www.sec.gov/about/offices/ocie/ocie_exambrochure.pdf.
[19] SEC, Annual Staff Report Relating to the Use of Form PF Data (December 30, 2019), https://www.sec.gov/files/2019-pf-report-to-congress.pdf.

staff generally reviews the adviser's Form ADV and Form PF filings as part of a routine pre-examination evaluation. This review, in combination with other data sources, provides SEC staff with an understanding of the adviser's current business, operations and investment strategy as well as an analysis of how this strategy has evolved or changed over different reporting periods. The staff has developed automated analyses and risk metrics that summarize and combine Form ADV data with key Form PF data about an adviser's private funds and advisory business. These reports are designed to assist staff in identifying potential reporting errors, compliance issues or other issues of interest for the examination team to consider.

OCIE is Leveraging Technology to Enhance Exam Capabilities

OCIE uses quantitative and predictive analytics to facilitate its risk process, enabling OCIE to direct its resources more efficiently and effectively.[20] For example, OCIE's National Exam Analytics Tool ("NEAT") enables examiners to access and systematically analyze years of trading data much more efficiently than in the past and has been expanded to support blotter data validations and options. Examiners can use NEAT to identify indicia of possible insider trading, front running, improper cross and principal trades, window dressing, improper allocations of investment opportunities and other kinds of misconduct. In most exams, the adviser will be asked to promptly provide a trade blotter, initial position report, employee trade blotter and a restricted list. The adviser will be provided with a template requesting that fields such as dates and times be formatted in a particular way. Trade blotters that cannot be quickly produced, are incomplete or contain errors may raise questions about the reliability of the registrant's data and the adequacy of the compliance program and portfolio management controls.[21]

An Exam Can Occur at Any Time — Be Prepared!

Certain proactive steps should be taken to prepare for the contingency of an examination. For example, an adviser should:

- Obtain and review sample SEC document request lists to anticipate likely staff requests;
- Make sure that its compliance program has been updated to reflect any new products, business lines or clients;
- Ensure that its disclosure documents (including filings with the SEC and other regulators), compliance policies and procedures and actual business and compliance practices are all consistent with one another;
- Make sure that all of its books and records are up to date and readily accessible;
- Review results from periodic and annual compliance reviews to make sure that findings have been addressed;
- Review previous SEC examination findings (if any) to make sure that past deficiencies have been remedied;
- Consider conducting a mock examination or gap analysis; and
- As recommended by OCIE, consider how best to present the adviser's business, key personnel and key risks to the examination staff and have a "first day" presentation ready to go.[22]

Exam Process

The books and records of all RIAs, including the records of any private funds to which the adviser provides investment advice, are subject to examination. Generally, an adviser being examined is required to provide the SEC with access to all books and records related to its advisory business, whether or not they are required to be kept. As noted above, while ERAs are subject to SEC examination, the SEC has noted that it does not expect to examine ERAs on a routine basis.

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[20] See Note 3 above.
[21] *Ibid.*
[22] *Ibid.*

While exams may be conducted on an announced or unannounced basis, exams usually are announced. In the case of an announced exam, the staff typically calls the CCO to inform the entity that it will be examined. At that point, the staff may either send the initial request list identifying certain information and documents that will be reviewed or schedule a call with the adviser to learn more about the business before sending the initial request list. In many cases, the staff will visit the firm; however, certain exams are conducted primarily by document submission and review and telephone interviews, sometimes followed by an on-site visit. When the exam is unannounced, the staff may provide the adviser with a document request list upon arrival and may conduct an initial interview. Initial document request lists vary depending on the nature and focus of the examination and may be followed by one or more subsequent request lists. The scope of recent exams has varied greatly. In some cases, the scope is relatively narrow, with an emphasis on several higher-risk areas.

The staff will review the information and documents provided and may request interviews with relevant personnel. The staff also may request relevant information and documents held by third-party service providers and may contact the firm's clients to gather additional information or to verify information provided. The length of the exam depends on a number of variables, including the scope of the exam, the complexity of the business, whether information is complete and provided in timely response to the exam team's requests and the accessibility of firm personnel for requested meetings and interviews. Following the on-site portion of an exam, the staff, in many cases, will perform additional analyses of the information obtained and may contact the adviser to ask clarifying questions or request additional information or documents. Typically, the staff will conduct an "exit interview" at the end of the exam to discuss, among other things, issues identified and give the adviser an opportunity to ask questions and provide additional information.

Most advisers that are examined receive an "exam findings" or "deficiency" letter, outlining technical and/or more serious compliance weaknesses or violations. The examined entity will be asked to respond in writing to any issues identified in the deficiency letter, including any steps that it has taken or will take to address the issues and to prevent their reoccurrence. The entity's response will generally be due within 30 days of the date of the letter. It is critically important that the adviser address all deficiencies, including revisions (as needed) to its compliance program and/or disclosure documents. SEC staff may consider even minor deficiencies, if not corrected, as serious when the next exam occurs, and the staff may take administrative or other enforcement action against such "recidivist" behavior.

If the exam staff identifies serious issues during an examination, in addition to sending the entity a deficiency letter, the staff may refer the issues to the SEC's Division of Enforcement for possible action.

Recent Regulatory Developments and Guidance That May Affect an Adviser's Compliance Program

The following regulatory developments may affect the compliance programs of certain advisers. Advisers should review these and other changes in applicable laws, rules, regulations and/or SEC staff guidance to determine whether compliance policies and procedures need to be added or revised.

Guidance on Cybersecurity and Operational Resiliency

In January 2020, OCIE issued observations from examinations of investment advisers and other SEC registrants to assist market participants in considering how to enhance cybersecurity preparedness and operational resiliency (the "Cybersecurity Guidance").[23] OCIE recognized at the outset of the report that there is no "one-size fits all" approach and that not all of the practices discussed in the report may be appropriate for any one firm. OCIE stated, "In sharing these staff observations, we encourage market participants to review their practices, policies and procedures with respect to cybersecurity and operational resiliency. We believe that assessing your level of preparedness and implementing some or all of the above measures will make your organization more secure."

[23] OCIE, Staff Guidance, "Cybersecurity and Resiliency Observations" (January 27, 2020), https://www.sec.gov/files/OCIE%20Cybersecurity%20and%20Resiliency%20Observations.pdf.

Governance and Risk Management. The Cybersecurity Guidance stresses that effective cybersecurity programs start with the right tone at the top. OCIE has observed firms utilizing the following risk management and governance measures:

- Devoting senior leadership attention to setting the strategy of and overseeing the firm's cybersecurity and resiliency programs;
- Conducting a risk assessment to identify, prioritize and mitigate cyber risks;
- Implementing, monitoring and testing comprehensive written cybersecurity policies and procedures;
- Continuously evaluating and adapting to changes; and
- Establishing communication policies and procedures to provide timely information to senior management, customers, employees, other market participants and regulators, as appropriate.

Access Rights and Controls. Access rights and controls are used to determine appropriate users for organization systems based on job responsibilities and to deploy controls to limit access to authorized users. OCIE has observed firms with strategies that include, for example:

- Developing a clear understanding of access needs to system and data;
- Managing user access through systems and procedures that implement separation of duties for user access approvals, re-certify access rights on a periodic basis and utilize multi-factor authentication; and
- Monitoring for unauthorized user access.

Data Loss Prevention. OCIE has observed the following data loss prevention measures, among others:

- Establishing a vulnerability management program that includes routine scans of software code, web applications, servers and databases, work stations and endpoints within both the firm and applicable third party providers;
- Implementing perimeter security capabilities that are able to control, monitor and inspect all incoming and outgoing network traffic to prevent unauthorized or harmful traffic;
- Maintaining an inventory of hardware and software assets, including identification of critical assets and information;
- Using tools and processes to secure data and systems through encryption and network segmentation; and
- Verifying that the decommissioning and disposal of hardware and software does not create system vulnerabilities.

Incident Response and Resiliency. OCIE has observed that many firms have incident response plans with the following elements, among others:

- Developing a risk-assessed incident response plan for various scenarios including denial of service attacks, malicious disinformation, ransomware, key employee succession, as well as extreme but plausible scenarios;
- Determining and complying with applicable federal and state reporting requirements;
- Testing the incident response plan and potential recovery times; and
- Developing a strategy for operational resiliency with defined risk tolerances tailored to the firm.

Vendor Management. OCIE has observed the following practices:

- Establishing a vendor management program to ensure vendors meet security requirements and that appropriate safeguards and implemented;

- Understanding all contract terms to ensure that all parties have the same understanding of how risk and security is addressed; and
- Monitoring the vendor relationship to ensure that the vendor continues to meet security requirements and to be aware of changes to the vendor's services or personnel.

Other topic areas covered in the Cybersecurity Guidance include establishing policies and procedures that address the additional and unique vulnerabilities associated with mobile devices and applications and the key role of cybersecurity training.

Guidance Regarding Proxy Voting and Proxy Advisors

In August 2019, the SEC published guidance to assist investment advisers in fulfilling their proxy voting responsibilities, particularly when relying on proxy advisors (e.g., ISS or Glass Lewis) (the "Proxy Voting Guidance").[24] The SEC encourages investment advisers to review their policies and procedures in light of the guidance.

The Proxy Voting Guidance underscores that an investment adviser is a fiduciary that owes each of its clients duties of care and loyalty regarding "all services undertaken on the client's behalf, including proxy voting." It also re-emphasizes that using a proxy advisor to assist with voting in no way relieves an investment adviser of its fiduciary duty to serve its client's best interest.

The SEC notes, among other things, that an investment adviser and its client may agree on the scope of the investment adviser's proxy voting authority and responsibilities. Investment advisers that assume proxy voting authority may establish a variety of voting arrangements with their clients, subject to full and fair disclosure and informed consent. For example, the investment adviser may vote according to specified parameters designed to serve the client's best interest (e.g., in favor of all management proposals) or may vote only on certain types of proposals (e.g., relating to significant corporate events) based on the client's preferences.

The SEC provides several examples of actions an investment adviser can take to ensure that it is making voting determinations in accordance with its proxy voting policies and procedures and in a client's best interest. The SEC recommends, among other things, that an investment adviser should consider:

- Applying a more detailed company-specific analysis for certain types of proposals (e.g., significant corporate events);
- Annually reviewing a sampling of the proxy votes it casts; and
- If it votes proxies on behalf of multiple clients with diverse investment goals, whether applying a uniform voting policy to all such clients would be in each of their best interests or whether different voting policies should apply.

The Proxy Voting Guidance provides a non-exhaustive list of factors the SEC believes an investment adviser should consider when deciding whether to retain (or continue to retain) a proxy advisor, including whether:

- The proxy advisor has the ability to adequately analyze the matters for which the investment adviser is responsible for voting;
- The proxy advisor has sufficiently informed the investment adviser about its methodologies in formulating voting recommendations; and

[24] Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, IA-5325 (August 21, 2019), https://www.sec.gov/rules/interp/2019/ia-5325.pdf. For a more detailed explanation of this release, see Sidley Austin LLP, Sidley Update, "SEC Publishes New Guidance on Investment Advisers' Proxy Voting Responsibilities and Reliance on Proxy Advisors" (August 27, 2019), https://www.sidley.com/en/insights/newsupdates/2019/08/sec-publishes-new-guidance-on-investment-advisers-proxy-voting.

- The proxy advisor's conflict of interest policies and procedures provide "context-specific, non-boilerplate" disclosure of the proxy advisor's actual and potential conflicts with respect to the services provided to the investment adviser.

The SEC stated that an investment adviser should consider taking certain steps if it becomes aware of potential factual errors, incompleteness or methodological weaknesses in a proxy advisor's analysis that may materially affect the investment adviser's voting determination and should consider evaluating a proxy advisor's services on an ongoing basis.

According to the Proxy Voting Guidance, even if an investment adviser has assumed voting authority on behalf of a client, it is not required to exercise every opportunity to vote a proxy for that client. Such instances include where (i) the investment adviser and its client agreed in advance to limit the conditions under which the investment adviser would cast a vote and (ii) the investment adviser has determined that refraining from voting is in the client's best interest (e.g., the cost exceeds the expected benefit).

Finally, an investment adviser should review and document at least annually that its voting policies and procedures are reasonably designed to ensure that the investment adviser votes in its clients' best interests.

Investment Adviser Standard of Conduct and Form CRS

On June 5, 2019, the SEC adopted new rules and interpretations related to the standard of conduct requirements for investment advisers and broker-dealers:[25]

- Regulation Best Interest ("Regulation BI"), a new rule imposing a "best interest" standard of conduct on broker-dealers making recommendations to retail clients;
- Broker-Dealer "Solely Incidental" Exclusion, a new interpretation of Section 202(a)(11)(C) of the Advisers Act, which excludes from the definition of "investment adviser" any broker or dealer that provides advisory services when such services are "solely incidental" to the conduct of the broker's or dealer's business and when such incidental advisory services are provided for no special compensation;
- Interpretation Regarding Standard of Conduct for Investment Advisers (the "IA Interpretation"), a new interpretation intended to clarify an investment adviser's fiduciary duty to its clients; and
- Form CRS Relationship Summary, a new rule requiring both broker-dealers and investment advisers to provide retail clients with summary information about the nature of their relationship.

Information regarding the IA Interpretation and Form CRS is provided below.

Standard of Conduct for Investment Advisers

The IA Interpretation,[26] which is largely consistent with previous SEC statements on the federal fiduciary standard, reaffirms and clarifies the SEC's view that an investment adviser owes a fiduciary duty to its clients under Section 206 of the Advisers Act. In the IA Interpretation, the SEC emphasizes that an adviser must (i) at all times serve the best interest of its client and not subordinate its client's interest to its own and (ii) make full and fair disclosure of all material facts, with particular attention to potential conflicts of interest.

The release interprets an investment adviser's obligations to all its clients (not only retail clients), but states that sophisticated clients such as registered investment companies ("RICs") and private funds are permitted to shape the scope of their relationships to which fiduciary duties apply. The release confirms that while no adviser can ask any client to waive fiduciary status entirely, "it will apply in a manner that reflects the agreed-

[25] For a more detailed explanation of these releases, see Sidley Austin LLP, Sidley Update, "SEC Adopts Regulation Best Interest and Form CRS; Issues Investment Advisers Act Interpretations" (June 13, 2019), https://www.sidley.com/en/insights/newsupdates/2019/06/sec-adopts-best-interest-standard-of-care-for-broker-dealers-clarifies-fiduciary-duty.
[26] SEC, Release No. IA-5248, "Commission Interpretation Regarding Standard of Conduct for Investment Advisers" (June 5, 2019), https://www.sec.gov/rules/interp/2019/ia-5248.pdf.

upon scope of the relationship." The release states that a client's informed consent following "full and fair" disclosure can be either explicit or, depending on the facts and circumstances, implicit. The question of whether a hedge clause seeking to limit an adviser's liability violates the Advisers Act's anti-waiver provisions depends on all of the surrounding facts and circumstances, including the sophistication of the client.

The IA Interpretation affirms that, generally speaking, an investment adviser can disclose conflicts for purposes of obtaining informed consent with no categorical duty to mitigate or eliminate those conflicts. However, the SEC states that if an investment adviser "cannot fully and fairly disclose a conflict of interest to a client such that the client can provide informed consent, the adviser should either eliminate the conflict or adequately mitigate (i.e., modify practices to reduce) the conflict such that full and fair disclosure and informed consent are possible." According to the SEC, stating that an adviser "may" have a conflict is insufficient if the conflict actually exists, but using the term "may" can be appropriate if the conflict does not currently exist but might reasonably present itself in the future.

Form CRS Relationship Summary

Effective June 30, 2020, RIAs must provide "retail investors" with summary information on Form CRS (new Form ADV Part 3) about the nature of their relationship.[27] For purposes of Form CRS, "retail investor" is defined as "a natural person, or the legal representative of such natural person, who seeks to receive or receives services primarily for personal, family or household purposes." (Notably, there is no exception for sophisticated natural person clients.) An investment adviser to a pooled investment vehicle, such as a hedge fund or private equity fund, that includes natural persons who may be "retail investors" as defined in Form CRS is not required to deliver a relationship summary to those investors or the fund.[28]

Form CRS must be delivered to each retail investor before or at the time the adviser enters into an investment advisory contract with the retail investor. If an adviser does not have any retail investors to whom it must deliver a relationship summary, it is not required to prepare or file one.

The form requires summary information about the types of client relationships and services the adviser offers; fees and costs; conflicts of interest; the required standard of conduct; disciplinary history of the firm and its financial professionals; and how to obtain additional information. Form CRS must be prepared in a question-and-answer format, with standardized questions functioning as the headings in a prescribed order. The adviser also must include follow-up questions for retail investors to ask their financial professionals as "conversation starters." Broker-dealers also must provide Form CRS to their retail investors; dual registrants can prepare one single Form CRS discussing both brokerage and investment services. The form must not exceed two pages for investment advisers and four pages for dual registrants. Form CRS must be updated within 30 days whenever the form becomes materially inaccurate.

For investment advisers, Form CRS must be filed electronically with the IARD filing system as Part 3 of Form ADV. Advisers that are required to file Form CRS and are already registered or have an application for registration pending with the SEC before June 30, 2020 must electronically file Form CRS beginning on May 1, 2020 and by no later than June 30, 2020, either as: (i) an other than-annual Form ADV amendment or (ii) part of the Form ADV initial application or annual updating amendment. As soon as the adviser has filed its first Form CRS online, delivery to new and prospective retail investors must begin. Form CRS must be delivered to existing retail investors within 30 days from the date the adviser has filed its Form CRS.

Principal and Agency Cross Trading Compliance Issues

On September 4, 2019, OCIE issued a Risk Alert identifying common issues regarding principal trading and

[27] SEC, Release No. IA-5247, "Form CRS Relationship Summary" (June 5, 2019), https://www.sec.gov/rules/final/2019/34-86032.pdf.
[28] See Frequently Asked Questions on Form CRS, https://www.sec.gov/investment/form-crs-faq (most recently updated on February 11, 2020).

agency cross transactions found during investment adviser examinations performed by OCIE over the last three years.[29] Below are examples of the most common deficiencies or weaknesses identified.

Principal Trading. OCIE staff observed advisers that did not appear to follow the specific disclosure and client consent requirements of Section 206(3) of the Advisers Act. For example, staff observed that:

- While acting as principal for their own accounts, some advisers purchased securities from and sold securities to individual clients without recognizing that such trades were subject to Section 206(3). Thus, these advisers did not provide the required written disclosures to clients or obtain client consent.
- Some advisers recognized that they engaged in principal trades with a client but did not meet all of the requirements of Section 206(3), such as failing to obtain appropriate prior client consent for each principal trade and/or failing to provide sufficient disclosure regarding the potential conflicts of interest and terms of the transaction.
- In some cases, client consent was obtained *after* the completion of the transaction.
- Some advisers effected trades between an advisory client and an affiliated fund, but failed to recognize that the adviser's significant ownership interests in the fund caused the transaction to be subject to Section 206(3).
- Some advisers effected principal trades between themselves and fund clients without obtaining consent from the fund prior to completing the transactions.

Agency Cross Transactions. Compliance issues noted in connection with agency cross transactions include:

- Some advisers engaged in agency cross transactions in reliance on Rule 206(3)-2, despite telling their clients that they would not engage in agency cross transactions.
- Some advisers effected agency cross transactions, purportedly in reliance on Rule 206(3)-2, but could not produce any documentation that they had complied with the written consent, confirmation and disclosure requirements of the rule.

OCIE staff also noticed advisers that engaged in principal trades and agency cross transactions without having adopted policies and procedures regarding such transactions, as well as advisers that had such policies and procedures in place but did not follow them.

OCIE encouraged advisers to review their policies and procedures, and the implementation of such policies and procedures, to ensure they are compliant with the principal trading and agency cross transaction provisions of the Advisers Act and the rules thereunder.

Safeguarding Customer Records and Information in Network Storage

On May 23, 2019, OCIE issued a Risk Alert identifying security risks associated with the storage of electronic customer records and information in various network storage solutions, including cloud-based storage.[30] Concerns identified during recent examinations include misconfigured network storage solutions, inadequate oversight of vendor-provided network storage solutions and insufficient data classification policies and procedures.

OCIE noted that implementing a configuration management system that includes policies and procedures governing data classification, vendor oversight and security features will help to mitigate the risks associated with on-premise or cloud-based network storage solutions. Examples of effective practices

[29] SEC National Exam Program Risk Alert, "Investment Adviser Principal and Agency Cross Trading Compliance Issues" (September 4, 2019), https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20Principal%20and%20Agency%20Cross%20Trading.pdf.
[30] SEC National Exam Program Risk Alert, "Safeguarding Customer Records and Information in Network Storage – Use of Third Party Security Features" (May 23, 2019), https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20Network%20Storage.pdf.

observed during examinations include:

- Policies and procedures designed to support the installation, on-going maintenance and regular review of the network storage solution;
- Guidelines for security controls and baseline security configuration standards; and
- Vendor management policies and policies that include regular implementation of software patches and hardware updates followed by reviews to ensure that the patches and updates did not unintentionally change or weaken the security configuration.

Among other points made in the Risk Alert, OCIE encouraged advisers to actively oversee any vendors they use for network storage to determine whether the service provided by the vendor is sufficient to enable the adviser to meet its regulatory responsibilities.

Compliance Issues Related to Regulation S-P – Privacy Notices and Safeguard Policies

In an April 16, 2019 Risk Alert, OCIE staff discussed compliance issues related to Regulation S-P identified during recent examinations of investment advisers.[31]

Privacy and Opt-Out Notices. OCIE staff noted, among other things, that some advisers did not provide initial privacy notices, annual privacy notices and opt-out notices to their customers as required by Regulation S-P. In other cases, the notices provided did not reflect the adviser's policies and procedures accurately and/or did not provide notice to customers of their right to opt-out of the adviser's sharing their nonpublic personal information with nonaffiliated third parties.

Lack of Policies and Procedures. OCIE also observed advisers that did not have written policies and procedures addressing administrative, technical and physical safeguards for the protection of customer records and information, as required by the Safeguards Rule of Regulation S-P.

Policies Not Implemented or Not Reasonably Designed. OCIE staff observed firms with written policies and procedures that did not appear to be implemented or reasonably designed to (i) ensure the security and confidentiality of customer records and information; (ii) protect against anticipated threats or hazards to the security of records and information; and (iii) protect against unauthorized access to or use of customer records or information. For example, staff observed:

- Policies and procedures that were not reasonably designed to safeguard customer information on personal devices;
- Inadequate employee training and monitoring with respect to the encryption, security and transmission of customer information;
- Failure to require outside vendors to contractually agree to keep customers' personal information confidential; and
- Inadequate incident response plans.

Developments in Privacy Law – New York, California and Cayman Islands

New York. On July 25, 2019, New York enacted the Stop Hacks and Improve Electronic Data Security Act ("SHIELD Act") to increase protections surrounding New York residents' personal data. Effective March 21, 2020, the SHIELD Act broadens, among other things, New York's data breach notification law by imposing notification requirements that apply to any entity or person with private information about New York residents; previously, such law applied only to those conducting business in New York. The SHIELD Act also expands the definition of "private information" to include biometric data and username and password

[31] SEC National Exam Program Risk Alert, "Investment Adviser and Broker-Dealer Compliance Issues Related to Regulation S-P – Privacy Notices and Safeguard Policies" (April 16, 2019), https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20Regulation%20S-P.pdf.

information or security questions and answers. Moreover, the SHIELD Act requires businesses to adopt "reasonable" administrative, technical and physical safeguards to prevent breach of such private information.

California. Effective January 1, 2020, California enacted the California Consumer Privacy Act (the "CCPA"), which is a comprehensive privacy law that regulates the disclosures companies have to make regarding their privacy practices and the privacy rights that businesses have to offer to California residents.[32] The CCPA governs a wide range of consumer personal data and, with certain exceptions, provides rights to California residents to access and delete their personal data maintained by businesses. The CCPA applies to companies "do[ing] business" in California that collect California consumers' personal information and that (i) have gross annual revenues of more than $25 million, (ii) receive, share or sell for commercial purposes the personal information of 50,000 or more California consumers, households or devices or (iii) derive 50% or more of its annual revenue from selling personal information. The CCPA also imposes requirements on businesses to maintain "reasonable security" regarding the protection of personal data and establishes a private cause of action for California consumers to recover statutory damages for data breaches that are the result of a failure to maintain reasonable security. The CCPA includes a number of limited exceptions, including an exception for data that is collected, processed, sold or disclosed pursuant to the Gramm-Leach-Bliley Act. This exception, however, does not apply to the private cause of action afforded to individuals for information security incidents.

Cayman Islands. Effective September 30, 2019, the Cayman Islands introduced The Data Protection Law (the "DPL") to regulate the privacy practices of entities established in or processing personal data in the Cayman Islands. "Personal data" includes any information relating to an identifiable natural person. The DPL requires regulated entities to, among other things, (i) provide notice of their collection and use of personal data, (ii) afford individuals the right to access their personal data and restrict its processing, (iii) maintain such data for no longer than necessary and (iv) restrict the transfer of personal data outside of the Cayman Islands only if certain conditions are satisfied. The DPL also includes data breach notification requirements.

Top Compliance Topics Observed in Examinations of RICs and Observations from Money Market Fund and Target Date Fund Initiatives

OCIE issued a Risk Alert[33] on November 7, 2019 outlining the most commonly cited compliance issues observed in its recent examinations of RICs.

Fund Compliance Rule. Pursuant to Rule 38a-1 under the 1940 Act, RICs are required to adopt and implement written policies and procedures that are reasonably designed to prevent violations of the federal securities laws, including policies and procedures that provide for the oversight of compliance for each investment adviser and certain other service providers of the fund. The most often cited deficiencies or weaknesses observed in connection with the fund compliance rule include:

- Compliance programs that did not take into account the business activities or risks specific to the fund;
- Policies and procedures that were not followed or enforced;
- Inadequate service provider oversight; and
- Failure to perform annual reviews addressing the adequacy of the RIC's policies and procedures.

[32] See Sidley Austin LLP, Sidley Resource, "California Consumer Privacy Act Monitor (CCPA)," https://www.sidley.com/en/insights/resources/ccpa; Sidley Austin LLP, Sidley Resource, "California, Here We Come: Getting Ready for the California Consumer Privacy Act," https://www.sidley.com/-/media/uploads/getting-ready-for-the-ccpa--sidley-client-guide.pdf?la=en.
[33] SEC National Exam Program Risk Alert, "Top Compliance Topics Observed in Examinations of Investment Companies and Observations from Money Market Fund and Target Date Fund Initiatives" (November 7, 2019), https://www.sec.gov/files/Risk%20Alert%20-%20Money%20Market%20Fund%20and%20Target%20Date%20Fund%20Initiatives.pdf.

Disclosure to Investors. In connection with fund disclosures to investors, the most often cited deficiencies or weaknesses observed involved funds that provided incomplete or potentially misleading information in their prospectuses, statements of information or shareholder reports as compared to the RIC's actual activities (e.g., failure to disclose a change to an investment strategy).

Board Approval of Advisory Contracts. Section 15(c) of the 1940 Act sets forth requirements for board approval of RIC advisory contracts. The most often cited deficiencies or weaknesses observed in connection with the Section 15(c) board approval process include the failure to request or consider reasonably necessary information and inadequate discussion as the basis of board approval.

Fund Code of Ethics Rule. Under Rule 17j-1, RICs are required to adopt a written code of ethics comprised of provisions reasonably necessary to prevent their "access persons" from engaging in fraudulent, deceptive or manipulative practices. The rule also requires reporting of certain personal trading transactions. According to the Risk Alert, the most often cited deficiencies or weaknesses observed in connection with the code of ethics rule involve failure to implement procedures reasonably necessary to prevent violations of the code of ethics; failure to follow or enforce the code of ethics; and failure to comply with the fund's approval and reporting obligations with respect to the code of ethics.

As part of OCIE's assessment of market-wide risks and matters of importance to retail investors and investors saving for retirement, the staff recently conducted examination initiatives focusing on money market funds and target date funds. The staff's observations from each of these examination initiatives also are described in the Risk Alert.

SEC Rule Developments

SEC Proposes Amendments to Advisers Act Advertising and Cash Solicitation Rules

On November 4, 2019, the SEC proposed amendments to modernize the rules under the Advisers Act addressing investment adviser advertisements (Rule 206(4)-1) and payments to solicitors (Rule 206(4)-3.[34] The proposed amendments are intended to update these rules to reflect advancements in technology, changes in investor expectations and the evolution of industry practices.

Proposed Amendments to the Advertising Rule. The proposed amendments to Rule 206(4)-1 would replace the rule's broad restrictions with principle-based provisions. The proposed rule incorporates certain principles set forth in no-action letters and guidance issued over the years and provides some flexibility based on the sophistication of the recipients and relevant disclosures. It contains general prohibitions of certain advertising practices, as well as more specific restrictions and requirements that are reasonably designed to prevent fraud with respect to specific types of advertisements. Subject to certain conditions, the proposed rule would permit references to "past specific recommendations" and the use of testimonials, endorsements and third-party ratings and would include tailored requirements for the presentation of performance results based on an advertisement's intended recipients. The proposed rule also would require internal review and approval of most advertisements and require each adviser to report additional information regarding its advertising practices in its Form ADV.

Proposed Amendments to the Cash Solicitation Rule. The proposed amendments to Rule 206(4)-3 would expand the rule to cover solicitation arrangements involving all forms of compensation rather than only cash and, in a significant and controversial change, would apply the rule to the solicitation of investors in private funds. The proposed amendments would retain several requirements of the current rule, including that an

[34] SEC, Release No. IA-5407, "Investment Adviser Advertisements; Compensation for Solicitations," https://www.sec.gov/rules/proposed/2019/ia-5407.pdf; see Sidley Austin LLP, Sidley Update, "SEC Proposes Amendments to Advisers Act Advertising and Cash Solicitation Rules" (November 13, 2019), https://www.sidley.com/en/insights/newsupdates/2019/11/sec-proposes-amendments-to-advisers-act-advertising-and-cash-solicitation-rules.

adviser enter into a written agreement with a solicitor to set forth the arrangements between the adviser and the solicitor. However, the adviser no longer would need to obtain a written acknowledgement from each referred client that the client had received the required disclosures from the solicitor, and a solicitor no longer would need to deliver a copy of the adviser's Form ADV Part 2A to the prospective client. The proposed amendments would add additional disciplinary events that would disqualify a person or firm from acting as a solicitor for an adviser, while also adding a limited carve-out for certain types of SEC actions.

SEC Proposes Rule to Regulate Sales Practices Regarding Shares of Certain Leveraged/Inverse Investment Vehicles as Part of Derivatives Regulation Proposal

On November 25, 2019, in conjunction with reproposing a new rule to regulate the use of derivatives by RICs (other than money market funds) and other entities, the SEC proposed new Rule 211(h)-1 under the Advisers Act that would require an RIA to exercise due diligence in approving a retail client's account to buy or sell shares of certain "leveraged/inverse investment vehicles."[35] The term "leveraged/inverse investment vehicles" includes certain entities that seek to provide investment returns that correspond to the performance of a market index by a specified multiple, or to provide investment returns that have an inverse relationship to the performance of a market index over a predetermined period of time. The entities included in the proposed scope of the sales practices rule would include RICs and certain exchange-listed commodity- or currency-based trusts or funds regulated by the CFTC.

Specifically, the proposed rule would require the adviser to: (i) approve the retail client's account for buying and selling shares of leveraged/inverse investment vehicles pursuant to a due diligence requirement and (ii) adopt and implement policies and procedures designed to achieve compliance with the proposed rule.

The rule would require an adviser to exercise due diligence to ascertain a set of "essential facts" about a retail client and his or her financial situation and investment objectives before placing an order for that client's account to buy or sell shares of a leveraged/inverse investment vehicle. An adviser could approve the retail client's account to buy or sell shares of leveraged/inverse investment vehicles only if the adviser had a reasonable basis to believe that the investor is capable of evaluating the risks associated with leveraged/inverse investment vehicles.

SEC Focus on Digital Assets and Related Activities

The SEC continues to focus on issues involving digital assets and blockchain technology. As noted above, OCIE indicated in its 2020 Exam Priorities Report that it will continue to identify SEC-registered market participants engaged in this space and monitor the sale, trading and management of digital assets.

The SEC also continues to engage in dialogue with market participants involved in digital asset activities. The Deputy Director and Chief Counsel of the SEC Division of Investment Management sent a letter to the Investment Adviser Association in March 2019 asking for input regarding the regulatory status of investment adviser and custodial trading practices that are not processed or settled on a delivery versus payment (Non-DVP) basis and the application of the Advisers Act Custody Rule to digital assets.[36] In July 2019, the SEC

[35] SEC, Release No. 34-87607, "Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/Inverse Investment Vehicles," https://www.sec.gov/rules/proposed/2019/34-87607.pdf. See also Sidley Austin LLP, Sidley Update, "SEC Proposes Rule to Regulate Sales Practices Regarding Shares of Certain Leveraged/Inverse Investment Vehicles" (January 6, 2020), https://www.sidley.com/en/insights/newsupdates/2020/01/sec-proposes-new-rule-to-regulate-sales-practices. See also Sidley Austin LLP, Sidley Update, "SEC Reproposes New Rule to Regulate Funds' Use of Derivatives" (January 6, 2020), https://www.sidley.com/en/insights/newsupdates/2020/01/sec-reproposes-new-rule-to-regulate-funds-use-of-derivatives.

[36] Letter from Paul G. Cellupica, Deputy Dir. and Chief Counsel, Div. of Inv. Mgmt., SEC, SEC Staff Letter, to Karen Barr, Pres. and CEO, Inv. Adviser Ass'n, Engaging on Non-DVP Custodial Practices and Digital Assets (March 12, 2019), https://www.sec.gov/investment/non-dvp-and-custody-digital-assets-031219-206.

Division of Trading and Markets and FINRA issued a joint statement offering guidance for noncustodial broker-dealer models, while also raising a number of custody concerns, including challenges for maintaining compliance with broker-dealer financial responsibility rules, and recordkeeping and reporting rules under the Securities Exchange Act of 1934 (the "Exchange Act") with respect to digital assets.[37]

During FY 2019, the SEC continued to bring actions against issuers of digital asset securities for engaging in fraud and/or violating the registration provisions of the federal securities laws.[38] As noted in the Division of Enforcement's 2019 Annual Report, FY 2019 saw the SEC file its first charges for unlawful promotion of initial coin offerings ("ICOs"), including charges filed against a "supposed" ICO research and rating service that did not disclose that it was compensated by some issuers whose offerings it rated. The SEC continues to actively investigate and bring digital asset-related enforcement actions.

In FY 2019, the SEC filed its first contested litigation against a digital asset issuer solely for non-fraud registration violations.[39] While the outcome of that litigation and another high profile matter related to whether a digital asset is a security may provide guidance, such a determination remains a facts and circumstances analysis. Although the Division of Enforcement did not bring any digital asset-related actions against fund managers in 2019, whether a particular digital asset is a security remains a threshold issue.[40]

Recent Enforcement Initiatives and Proceedings

The following is a summary of several recent enforcement actions of relevance to investment advisers.

Compliance Failures Related to Valuation of Fund Assets

The SEC settled charges with a large RIA and its primary trader for alleged violation of the Compliance Rule by failing to adopt and implement reasonably designed compliance policies and procedures relating to valuation of fund assets and failing to implement the RIA's existing policy.[41]

According to the SEC order, although the RIA had written policies regarding valuation, they were deficient in a number of respects. Specifically, although the firm's policies stated it would value securities at "fair value" in accordance with Accounting Standards Codification 820 ("ASC 820"), the SEC observed that the firm's written policies "lacked procedures on valuation regarding how, in the context of the specific markets relevant to [a fund] and the specific types of inputs available to [the RIA], it should ensure consistency with the requirements of ASC 820 for the positions they valued." The SEC also stated that the policies "did not mention any valuation techniques or methodologies, and further lacked procedures designed to promote consistency in valuation and to reduce the potential conflict of interest arising from the role of traders valuing securities they managed."

Additionally, the SEC found that the RIA had failed to implement its existing valuation policy. For instance, although the firm had a policy to value bonds based on "observable inputs such as market transactions and

[37] See Sidley Austin LLP, Sidley Update, "Digital Asset Securities: Joint SEC and FINRA Statement Aimed at Broker-Dealer Custody" (July 11, 2019), https://www.sidley.com/en/insights/newsupdates/2019/07/digital-asset-securities, for additional information regarding the statement.
[38] SEC Division of Enforcement, 2019 Annual Report (November 6, 2019), https://www.sec.gov/enforcement-annual-report-2019.pdf.
[39] *Ibid.*
[40] In 2018, the SEC issued its first-ever enforcement action against a digital asset hedge fund manager based on its investments in digital assets, for failing to register its fund as an investment company and offering and selling the fund's securities in an unregistered offering. This was also the first instance in which the SEC has found that certain digital assets are investment securities for purposes of the 1940 Act. See Sidley Austin LLP, Sidley Update, "One-Two-Three Punch: SEC and FINRA Announce Actions Against Unregistered Broker, Digital Asset Manager and FINRA Registered Person" (September 18, 2018), https://www.sidley.com/en/insights/newsupdates/2018/09/sec-and-finra-announce-actions, for additional information regarding enforcement proceedings involving participants in the digital asset markets.
[41] SEC Administration Proceeding File No. 3-19190 (June 4, 2019), https://www.sec.gov/litigation/admin/2019/ia-5245.pdf.

market information over unobservable inputs such as assumption about inputs," in practice the traders would rely on assumptions rather than on trading activity. According to the SEC, part of the firm's failure to implement its policy was due to the makeup of the RIA's risk committee. The committee, which was responsible for ensuring the fund was in compliance with the firm's pricing source protocol, was composed of individuals who lacked expertise in bond valuation and therefor were unqualified to determine whether bonds were valued in accordance with Generally Accepted Accounting Principles ("GAAP").

Failure to Disclose Conflict of Interest; Use of Client Assets for Personal Benefit

The SEC settled charges with an RIA and its sole owner for alleged failure to disclose a conflict of interest in connection with certain investment recommendations.[42] According to the SEC, the RIA had an arrangement with a third-party firm for a loan and access to a line of credit under terms that created an incentive for the RIA to recommend investments in the firm to the RIA's clients. The SEC found that the RIA recommended such investments to clients without disclosing this conflict of interest to its clients. Furthermore, the SEC found that the RIA failed to disclose this conflict of interest in its Form ADV.

Additionally, the SEC alleged that the owner, through the RIA, advised a client to purchase an interest in the RIA, representing that the investment would be used to support and expand the RIA's business. The SEC found that instead, the owner used half of the client's investment for his personal benefit, including paying his personal taxes and debt. The SEC found that the investment was fraudulently obtained from the RIA's client.

Custody Rule Violations; False Statements in Form ADV; Failure to Conduct Annual Compliance Program Review

A former RIA settled SEC charges that it violated the Custody Rule, made false statements in its Form ADV and failed to conduct an annual review of its compliance program.[43]

With respect to a private fund that it advised, the RIA attempted to rely on the "audit provision" of the Custody Rule, which requires an adviser to distribute a fund's audited financial statements prepared in accordance with GAAP to the fund's investors within 120 days of the fund's fiscal year end, as a means of complying with the relevant provision of the Custody Rule. According to the SEC, the RIA failed to distribute the audited financial statements to investors, either within 120 days of the fund's fiscal year end or at any time thereafter. The RIA engaged an audit firm to conduct an annual audit of the fund's financial statements for fiscal years 2012 through 2015. However, for each of those years, the audit firm was not able to complete the audit and express an opinion on whether the fund's financial statements were prepared in accordance with GAAP. Instead, for each year, the audit firm issued a report well after 120 days following the fiscal year end, in which the firm stated that it was not able to obtain sufficient audit evidence to provide a basis for the audit opinion. The SEC noted that such disclaimer does not constitute the performance of an audit in compliance with GAAP and therefore did not comply with the Custody Rule. For fiscal year 2016, the RIA was unable to engage an accountant to audit the fund's financial statements.

The SEC also found that the RIA made Form ADV filings during this period stating that it had distributed audited financial statements prepared in accordance with GAAP to investors when it had not in fact done so. The RIA also stated that it had "not yet received a report" in response to the question of whether the audit report contained an unqualified opinion and failed to file an amended Form ADV updating the response to "no" when the report was received. The SEC found that in making these representations, the RIA violated Section 207 of the Advisers Act by filing a Form ADV with untrue statements of material facts.

Additionally, the SEC found that the RIA failed to comply with the requirement under the Compliance Rule to adopt and implement written policies and procedures reasonably designed to prevent violations of the

[42] SEC Administrative Proceeding File No. 3-19227 (July 1, 2019), https://www.sec.gov/litigation/admin/2019/33-10655.pdf.
[43] SEC Administrative Proceeding File No. 3-19448 (September 13, 2019), https://www.sec.gov/litigation/admin/2019/ia-5344.pdf.

Advisers Act and the rules thereunder, including the Custody Rule, and to conduct an annual review of the adequacy and effectiveness of its policies and procedures.

Misleading Fund Clients to Benefit Parent Firm

The SEC settled an enforcement action against two RIAs relating to alleged violations of the Advisers Act anti-fraud provisions, as well as the requirement under the Compliance Rule to adopt and implement written policies reasonably designed to prevent violations of the Advisers Act. The SEC cited the RIAs failure to (i) adequately disclose their securities lending recall practice involving 94 mutual funds they advised and failure to disclose the related conflict of interest, and (ii) timely reimburse the funds for certain tax expenses.[44] The SEC found that the funds were reorganized so that the RIAs' parent company could receive certain tax benefits. These benefits to the parent, however, came with negative consequences to the funds.

According to the SEC, when the RIAs sought approval from the fund boards to reorganize the funds as partnerships for tax purposes, the RIAs disclosed that the purpose was to increase a tax benefit to the RIAs' affiliates but failed to disclose the adverse impact to the funds of the securities lending recall practice or the related conflict of interest. Additionally, the SEC found that the RIAs did not disclose or fully describe the recall practice during an examination later conducted by the SEC, but the SEC order acknowledges that the RIAs subsequently self-reported the conduct (as well as the foreign tax issue discussed below) to the SEC, cooperated with the staff's investigation, and voluntarily reimbursed the funds.

Also, because of the reorganizations, the funds were subject to less favorable tax treatment in certain foreign jurisdictions. The SEC found that, while the RIAs assured the boards that the funds would be reimbursed for this less favorable treatment, they failed to adequately reimburse the funds for a period of 12 years.

Share Class Selection Disclosure Initiative

The SEC continues to focus on disclosure failures relating to marketing and distribution fees, often referred to as "12b-1 fees," paid by investors in certain share classes of mutual funds. OCIE exams revealed numerous instances of advisers that selected a more expensive share class for investors when a lower-cost share class for the same fund was available, without making adequate disclosure to investors. In response, the SEC Division of Enforcement launched the Share Class Selection Disclosure Initiative (the "Initiative") in February 2018 to encourage investment advisers to self-report when this occurs.

The SEC announced on September 30, 2019 that it had settled charges with an additional 16 investment advisers for failure to disclose information regarding their mutual fund share class selection practices.[45] The advisers had self-reported as part of the Initiative and, as a result, were not ordered to pay any civil penalties. The charges against these advisers were in addition to the charges against 79 advisers that participated in the initiative and that were charged by the SEC in March 2019.

The SEC also announced on the same date that it had settled charges with another RIA for failure to disclose information regarding its mutual fund share class selection practices.[46] The RIA was eligible to self-report under the initiative but failed to do so. According to the SEC, the RIA failed to fully disclose conflicts of interest that arose with regards to its selection of more expensive mutual fund share classes for clients when there were lower-cost share classes available for the same fund. As a result of the RIA failing to self-report, it was ordered to pay a civil penalty.

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[44] SEC Administrative Proceeding File No. 3-19455 (September 16, 2019), https://www.sec.gov/litigation/admin/2019/ia-5346.pdf.
[45] SEC Press Release 2019-200, "SEC Orders an Additional 16 Self-Reporting Advisory Firms to Pay Nearly $10 Million to Investors" (September 30, 2019), https://www.sec.gov/news/press-release/2019-200.
[46] SEC Administrative Proceeding File No. 3-19554 (September 30, 2019), https://www.sec.gov/litigation/admin/2019/ia-5387.pdf.

Form PF Reporting Requirements

Most RIAs that advise private funds are required to file Form PF either quarterly or annually; advisers exempt from SEC registration, including ERAs, are not required to file Form PF. Form PF, which is a joint form between the SEC and the CFTC with respect to Sections 1 and 2 of the form, is filed with the SEC via the Private Fund Reporting Depository ("PFRD") electronic filing system and is not publicly available.

Given the volume and complexity of the work involved, many private fund advisers face a number of challenges in preparing Form PF, including making decisions regarding (and documenting) assumptions and methodologies, due to the ambiguous or subjective nature of a number of Form PF's instructions, definitions and questions. The SEC staff has provided assistance with respect to these issues and other Form PF questions, both directly in response to private inquiries[47] and in FAQs posted (and periodically updated) on the SEC's website.[48] According to a December 2019 SEC staff report, the staff regularly contacts individual filers when staff members identify anomalous and possibly erroneous data as well as possibly delinquent or missing filings and works with these individual filers to determine steps for improving timeliness and accuracy of filings.[49]

When delinquencies persist, the staff has taken further steps to ensure that information is appropriately filed. In June 2018, the SEC announced settlement orders with 13 RIAs that repeatedly failed to file Form PF.[50] Each adviser was charged a $75,000 penalty. During the course of the SEC investigation, the advisers remediated their failures by making the necessary filings.

Who Must File

An RIA is required to file Form PF if it (i) advises one or more private funds and (ii) collectively, with related persons (other than related persons that are separately operated), had RAUM of $150 million or more (calculated in accordance with Form PF aggregation requirements) attributable to private funds as of the end of its most recently completed fiscal year.

CFTC-registered CPOs that are dually registered with the SEC and are required to file Form PF must submit information with respect to each advised commodity pool that also is a private fund. Because commodity pools are considered hedge funds for purposes of Form PF, the filing adviser must complete the sections of the form applicable to hedge funds for each commodity pool reported on Form PF. For a dual registrant, filing Form PF can serve to satisfy certain CFTC Form CPO-PQR reporting requirements. Dual registrants also have the option of using Form PF to satisfy certain CFTC reporting requirements with respect to commodity pools that are not private funds in lieu of completing certain sections of Form CPO-PQR.[51]

To avoid duplicative reporting, Form PF information regarding subadvised funds should be reported by only one adviser. The adviser that completes information in Form ADV Schedule D Section 7.B.1 with respect to any private fund is also required to report that fund on Form PF. If, however, the adviser reporting the private fund on Form ADV in Section 7.B.1 is not required to file Form PF (i.e., because it is an ERA), then another adviser, if any, to the fund, if required to file Form PF, must report the fund on Form PF.

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[47] The public Form PF inquiry email address and a phone number to reach staff with questions relating to Form PF are available at https://www.sec.gov/divisions/investment/iard/iardhelp.shtml.

[48] See Form PF Frequently Asked Questions, http://www.sec.gov/divisions/investment/pfrd/pfrdfaq.shtml (most recently updated on January 18, 2017). FINRA, as administrator for the PFRD filing system, also posts information to assist Form PF filers, including PFRD System Frequently Asked Questions, http://www.iard.com/pfrd/pdf/PFRD_System_FAQs.pdf (most recently updated on January 18, 2017).

[49] See Note 19 above.

[50] SEC Press Release 2018-100, "SEC Charges 13 Private Fund Advisers for Repeated Filing Failures" (June 1, 2018), https://www.sec.gov/news/press-release/2018-100.

[51] Regardless of any reporting on Form PF, however, all registered CPOs and CTAs are required to file at least Schedule A of CFTC Form PQR and Form CTA-PR, as applicable, and comply with the requirements of NFA Form PQR.

Determining an Adviser's Filing Category

The scope of required Form PF disclosure, the frequency of reporting and filing deadlines differ based on the RAUM of the adviser attributable to different types of private funds (in particular, hedge funds, liquidity funds and private equity funds). Accurately determining an adviser's filing category is a critical first step. Specific definitions of fund types are provided in the Form ADV Part 1A Instructions and the Form PF: Glossary of Terms.

The RAUM thresholds applicable to different categories of Form PF filers are summarized in the chart below. An adviser meeting only the minimum $150 million private fund RAUM reporting threshold, as well as a large private equity fund adviser, must file Form PF annually within 120 days of its fiscal year end. A large liquidity fund adviser or large hedge fund adviser must file quarterly, within 15 days (for large liquidity fund advisers) and 60 days (for large hedge fund advisers) of its fiscal quarter end.

Advisers are required to follow certain aggregation instructions for purposes of determining whether they meet the *de minimis* $150 million private fund asset threshold for reporting on Form PF as well as the pertinent large private fund adviser thresholds. Aggregation also is required for large hedge fund advisers to determine whether any hedge fund is a "qualifying hedge fund" subject to additional reporting requirements. The aggregation instructions (and, conversely, certain netting instructions for fund-of-funds advisers and others whose funds invest in other private funds) may raise challenging interpretive issues for many advisers.

Frequency of Reporting and Filing Deadlines

The reporting frequency and upcoming filing deadlines for different categories of Form PF reporting advisers are summarized below. The filing deadlines set forth in the following table are for advisers with a December 31 fiscal year end.

	Large Hedge Fund Adviser	**Large Liquidity Fund Adviser**	**Large Private Equity Fund Adviser**	**Smaller Private Fund Adviser**
RAUM Threshold	$1.5 billion or more attributable to hedge funds as of the end of any month during the preceding fiscal quarter	$1.0 billion or more in combined liquidity fund and registered money market fund assets as of the end of any month during the preceding fiscal quarter	$2.0 billion or more attributable to private equity fund assets as of the end of the most recent fiscal year	$150 million or more (but less than the applicable "large" adviser threshold) attributable to private funds as of the end of the most recent fiscal year
Reporting Frequency	Quarterly	Quarterly	Annually	Annually
Reporting Deadline*	60 days from end of fiscal quarter	15 days from end of fiscal quarter	120 days from fiscal year end	120 days from fiscal year end

Applicable Form PF Sections	Sections 1 and 2	Sections 1 and 3	Sections 1 and 4	Sections 1
Upcoming Filing Deadline	February 29, 2020 (for fourth quarter 2019)	April 15, 2020 (for first quarter 2020)	April 29, 2020 (for 2019)	April 29, 2020 (for 2019)

*If the filing due date falls on a holiday, a weekend or a day when the PFRD system is closed, the Form PF filing will be considered timely filed with the SEC if filed no later than the following business day.

How the SEC Staff Uses Form PF Data

While the primary aim of Form PF was to create a source of data for the Financial Stability Oversight Council's assessment of systemic risk, the SEC is also using the data to support its own regulatory programs, including examinations, investigations and investor protection efforts. As noted above, OCIE staff generally reviews an adviser's Form PF filing as a part of its pre-exam evaluation and reviews information contained in the filing for inconsistencies with other information obtained during an exam, such as due diligence reports, pitch books, offering documents, operating agreements and books and records. In addition, OCIE staff typically looks for discrepancies between an adviser's Form PF filing and any publicly available documents related to the adviser, including the adviser's Form ADV Part 1A and its Part 2A brochure.

The most recent SEC annual Form PF staff report describes a number of ways the staff is using Form PF data to identify and monitor private fund industry trends, identify emerging compliance risk areas, inform policymaking and prioritize the use of exam and enforcement resources.[52] As described in the report, the SEC staff has developed various analytical tools to enhance the staff's ability to assess large volumes of data, streamline analysis of the data by automating certain analytic processes and evaluate Form PF data in conjunction with other relevant datasets. For example, these tools have enhanced the staff's ability to

- Identify "outliers" among private funds and private fund advisers using factors such as performance, investment exposures and liquidity;
- Identify private funds based on one or more areas of policy interest, such as type of strategy, types of investments, use of derivatives and extent of leverage; and
- Empirically test claims made in the financial press or other public sources regarding private funds and the private fund industry.

The SEC staff also obtains and reviews Form PF information to focus its enforcement investigations, including investigations of private fund advisers. For example, the staff used Form PF data together with other information to identify hedge fund advisers whose reported data — such as returns, exposures, liquidity — appear inconsistent with the funds' investment strategies or other benchmarks. These reviews have, in certain cases, led to examinations and enforcement investigations.

Reporting Requirements for Certain Investment Advisers on CFTC and NFA Form CPO-PQR and/or Form CTA-PR

Many advisers to privately offered funds and RICs are required to register as CPOs and/or CTAs with the CFTC with respect to certain commodity pools that they advise and to become members of the NFA. CFTC-registered CPOs and CTAs must report certain information on CFTC and NFA Form CPO-PQR (also referred to herein as CFTC Form PQR and NFA Form PQR, as applicable) and Form CTA-PR and NFA PR, respectively. The forms must be filed electronically using the NFA's EasyFile System.

[52] See Note 19 above.

CFTC and NFA Reporting Requirements on Form CPO-PQR

The scope of required disclosure, the frequency of reporting and whether a given Form CPO-PQR filing is required by the CFTC and/or NFA is determined generally by the CPO's aggregated gross pool assets under management (Gross AUM). As in the case of Form PF, Form CPO-PQR filers are required to follow certain aggregation instructions for purposes of determining the applicable filing category. The CFTC's

Division of Swap Dealer and Intermediary Oversight has posted FAQs regarding Form CPO-PQR, while the NFA has posted FAQs regarding Form PQR.[53]

Based on the information that the CPO enters on the cover page of Form CPO-PQR, all subsequent screens of the form will be dynamically generated to present only required schedules.[54]

As noted above, advisers that are dually registered with the SEC and the CFTC can satisfy certain CFTC Form PQR filing requirements by filing Form PF.[55] For example, a large CPO that is a quarterly Form PF filer can file Form PF Sections 1 and/or 2 in lieu of CFTC Form PQR Schedules B and C. Each of these filings is due within 60 days of quarter end. Similarly, a midsize CPO that is an annual Form PF filer can file Form PF Sections 1.b and 1.c in lieu of CFTC Form PQR Schedule B. A dual registrant is required only to submit Schedule A of CFTC Form PQR annually; however, a dual registrant will still be subject to quarterly NFA reporting requirements pursuant to NFA Form PQR. Note, however, that whereas a midsize CPO must meet its CFTC Form PQR reporting obligation within 90 days of calendar year end, the filing deadline for an annual Form PF filer is 120 days from fiscal year end. Hence, a midsize CPO that wishes to meet a portion of its CFTC reporting requirements through Form PF may need to file its Form PF within 90 days (rather than 120 days) of its year end (assuming a calendar year fiscal year).

With respect to co-CPOs, the CPO with the greater Gross AUM is required to report for the pool. If a pool is operated by co-CPOs and one of the CPOs is also a dual registrant that files Form PF Sections 1 and/or 2 (and thus is only required to file CFTC Form PQR Schedule A), the non-investment-adviser CPO must nevertheless file the applicable sections of CFTC Form PQR.

Each CPO that is an NFA member must file NFA Form PQR quarterly within 60 days of the quarters ending in March, June and September and a year-end report within 60 or 90 days (depending on the size of the CPO) of the calendar year end. Large CPOs that file the required CFTC Form PQR schedules quarterly satisfy their NFA Form PQR filing requirements through filing CFTC Form PQR.[56]

CPOs that file Form PF with the SEC in lieu of certain portions of CFTC Form PQR are required to file NFA Form PQR with the NFA quarterly within 60 days of the quarter end, except for the December 31 quarter, when the filing will be due within 90 days.[57]

CFTC Form PQR and NFA Form PQR filing requirements are summarized in the following chart.

[53] See CFTC, "CFTC Division of Swap Dealer and Intermediary Oversight Responds to Frequently Asked Questions Regarding Commission Form CPO-PQR" (November 5, 2015), http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/faq_cpocta110515.pdf. See also NFA, "CPO Form PQR," https://www.nfa.futures.org/faqs/members/CPOFormPQR.html.
[54] See Form CPO-PQR Filing System Overview (on the NFA website), http://www.nfa.futures.org/electronic-filing-systems/PQR-Help.pdf.
[55] Form PF filing deadlines are based on the adviser's fiscal year (or quarter), while Form CPO-PQR/Form CTA-PR filing deadlines are based on the calendar year (or quarter). Note that dual registrants with a fiscal year that differs from the calendar year may have difficulty using Form PF to satisfy their CFTC Form PQR filing obligations.
[56] As noted above, all registered CPOs must file CFTC Form PQR Schedule A. Quarterly CFTC Form PQR filers also file Schedule B, which contains a Schedule of Investments.
[57] While Form PF may fulfill certain CFTC filing requirements, it does not fulfill the NFA quarterly filing requirements.

Gross AUM Threshold				
Filing Requirements	**Large CPO***	**Mid-Size CPO****	**Small CPO*****	**CPO That Files Form PF in Lieu of CFTC Form PQR Schedules B and C**
First Quarter	CFTC Form PQR Schedules A, B, C# (*within 60 days of quarter end*)##	NFA Form PQR (*within 60 days of quarter end*)	NFA Form PQR (*within 60 days of quarter end*)	NFA Form PQR (*within 60 days of quarter end*)
Second Quarter	CFTC Form PQR Schedules A, B, C# (*within 60 days of quarter end*)##	NFA Form PQR (*within 60 days of quarter end*)	NFA Form PQR (*within 60 days of quarter end*)	NFA Form PQR (*within 60 days of quarter end*)
Third Quarter	CFTC Form PQR Schedules A, B, C# (*within 60 days of quarter end*)##	NFA Form PQR (*within 60 days of quarter end*)	NFA Form PQR (*within 60 days of quarter end*)	NFA Form PQR (*within 60 days of quarter end*)
Fourth Quarter	CFTC Form PQR Schedules A, B, C# (*within 60 days of quarter end*)##	CFTC Form PQR Schedules A, B (*within 90 days of calendar year end*)##	CFTC Form PQR Schedule A + NFA Form PQR (*within 90 days of calendar year end*)	CFTC Form PQR Schedule A + NFA Form PQR (*within 60 or 90 days, depending on the size of the CPO*)

* $1.5 billion or more attributable to aggregated pools as of the close of business on any day during the most recent calendar quarter.

** $150 million or more (but less than the applicable "large" CPO threshold) attributable to aggregated pools as of the close of business on any day during the most recent calendar year.

*** Less than $150 million attributable to aggregated pools as of the close of business on each day during the most recent calendar year.

Schedule C Part 2 applies only to any pool that has a net asset value individually, or in combination with any parallel pool structure, of at least $500 million.

Satisfies the NFA filing requirement.

Form CTA-PR

Each registered CTA is required to file an annual Form CTA-PR with the CFTC within 45 days of the calendar year end and a quarterly NFA Form CTA-PR within 45 days of the calendar quarter end.[58] The same form is used for both the CFTC and the NFA filings. All Form CTA-PR filings are made through the NFA's EasyFile System. The CFTC and the NFA have posted FAQs regarding Form CTA-PR.[59]

[58] See CTA Form PR Manual (on the NFA website), https://www.nfa.futures.org/electronic-filing-systems/CTA-PR-System-Help.pdf.
[59] See CFTC, "CFTC Division of Swap Dealer and Intermediary Oversight Responds to Frequently asked Questions Regarding Commission Form CTA-PR" (in the same release as the CFTC's FAQs regarding Form CPO-PQR cited in Note 51 above). See also NFA, "CTA Form PR FAQs," https://www.nfa.futures.org/NFA-electronic-filings/CTAFAQsFormPR.pdf.