COVID-19 WEBINAR SERIES

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Focus on Fund Managers: Where SEC Exam and Enforcement Staff May Redirect Attention in the Wake of COVID-19

W. Hardy Callcott • Kevin J. Campion • Benson R. Cohen
Laurin Blumenthal Kleiman • Barry W. Rashkover

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BACKGROUND

Background

- Prior to COVID-19 crisis, the SEC had shifted substantial OCIE exam resources to investment advisers.
  - Starting in FY 2017, the SEC moved over 100 examiners from broker-dealers to investment advisers and hired new investment adviser examiners.
  - As a result, the SEC was successful in increasing the percentage of investment advisers examined from under 10% per year to over 15% per year in FY 2018 and 2019.
- In FY 2019, the SEC brought 191 enforcement actions against investment advisers and investment companies, a record 36% of its total enforcement docket.
  - Almost half of these cases, 95, came from the mutual fund share class selection disclosure initiative, which primarily affected retail investors.
  - SEC continued its focus on private funds, especially on expense disclosures, calculations and allocation.
  - The Asset Management Unit is the largest of the SEC's specialized enforcement units.
- In light of the COVID-19 market volatility, we expect the SEC's attention to shift back from "Main Street" retail investors to systemic risk and financial stability (as it did after the 2008-09 financial crisis) – which will mean an increased focus on larger and more leveraged funds and managers.

THE FINANCIAL CRISIS PLAYBOOK:
ISSUES FROM 2008 POISED TO MAKE A REPRISE

Short Sales

- *Short Sale Ban?* While in September 2008 the SEC issued Emergency Orders generally prohibiting short sales in certain financial companies, the SEC has to date indicated that it does not intend to take such action during the current market crisis.
  - Different than in 2008, the SEC's Regulation SHO now includes an "uptick rule" which restricts execution of short sales in a manner that could lead to further de-stabilization in the stock price.
- *European Short Bans/Application to U.S. Trading:* Certain EU Member State regulators (Austria, Belgium, France, Italy, Greece, Spain) have imposed bans on creating or increasing net short *positions* in their securities (not just a short sale in the shares themselves) – a net short position includes a position resulting from "entering into a transaction which creates or relates to a financial instrument … where the effect or one of the effects of the transaction is to confer a financial advantage on the natural or legal person entering into that transaction in the event of a decrease in the price or value of the share or debt instrument." See Commission Regulation 236/2012, 2012 O.J. (L 86) 9.
  - The EU Member State regulators interpret their respective bans as applying to short positions in the restricted shares through ADRs/GDRs as well as certain indices, baskets and ETFs. The bans have also been expressed as applying to any natural or legal person, irrespective of country of residence and regardless of whether trading occurs in an EU or non-EU country.
  - Note that the SEC can conduct investigations to aid non-U.S. regulators concerning potential violations of non-U.S. law.

Short Sales

- Separately, it is also expected that the SEC will be aggressive in investigating funds for compliance with existing U.S. short sale restrictions under Regulation SHO, including the following:
  - Marking Requirement: Sell orders in equity securities are required to be properly marked as "long" or "short" – orders can only be marked "long" if the seller has a net long position and intends to deliver the security being sold.
  - Locate Requirement: Prior to effecting a short sale, a fund must receive a "locate" from its broker, indicating the broker has reasonable grounds to believe that the security can be borrowed.
  - Alternative Uptick Rule: Applies to securities that have a price decrease of at least 10% from the prior day's close, and prevents short sales from being effected at a price at or below the National Best Bid (NBB) for the remainder of the day and the following day.
  - Naked Short Selling Anti-Fraud Rule: Rule 10b-21 generally makes it unlawful for any fund to submit an order to sell a security and misrepresent to their broker that: (i) a "locate" has been obtained from a specific source (who did not actually provide a locate); or (ii) they are "long" the securities being sold (but actually do not own the shares).
- The SEC will likely also continue to be aggressive with respect to other short sale restrictions, such as:
  - Rule 105 of Regulation M: Prevents funds from generally purchasing in a SEC-registered offering if short sales were effected during a "restricted period" which is generally 1-5 business days prior to pricing.
  - Partial Tender Offers: Rule 14e-4 states that a person may tender shares into a partial tender offer only if both at the time of the tender and at the end of the proration period the person has a "net long position" in the security that is the subject of the tender offer.

False Rumors/Idea Dinners

- In the wake of the 2008 financial crisis, the SEC opened a number of investigations to determine whether hedge funds were conspiring together to short financial companies, including by disseminating false rumors concerning such companies.
- As part of these investigations, the SEC paid close attention to situations in which hedge fund portfolio managers attended “idea dinners” or other meetings to discuss potential short targets.
- Whether or not there is compliance with the applicable short sale regulations, the general anti-fraud and anti-manipulation provisions of the federal securities laws (including Section 17(a) and 9(a) of the Exchange Act, and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder) would prohibit trading activity designed to improperly influence the price of a security.
- In light of recent market events, it may be prudent to remind fund employees that they are prohibited from intentionally creating or spreading rumors that are designed to manipulate the price of securities, and should avoid discussing unsubstantiated information with clients and other third parties.
- Also, while it is unlikely that there would be “idea dinners” in the current social-distancing environment, to the extent that hedge fund portfolio managers contemplate participating in similar types of virtual meetings/calls, it would be prudent to ensure that there is involvement by the Legal and Compliance department to help ensure that any proposed attendance is carefully controlled so as not to raise manipulation concerns with respect to short ideas, and/or 13(d) “group” concerns with respect to long ideas.

PROPPING UP FUND PERFORMANCE/VALUATION

Style Drift

- "Style drift" is where an adviser begins to trade pursuant to strategies or objectives not contemplated by the offering memorandum, ADV or other investor disclosures.
- The SEC has brought several cases charging style drift over the years. Two are illustrative:
  - UBS Willow Mgmt., Inv. Adv. Rel. No. 4233 (Oct. 16, 2015). Investment adviser UBS Willow Management ("UWM") and its managing member UBS Fund Advisor ("UFA") agreed to pay over $17M, to settle charges stemming from UWM's failure to inform investors it switched the investment strategy of its advisee-fund from investing in distressed debt to shorting distressed debt, and UFA's failure to supervise UWM.
  - James Caird Asset Mgmt., Inv. Adv. Rel. No. 4413 (June 2, 2016). The SEC charged investment adviser JCAM with operating "in a manner inconsistent with [it's] prior disclosures" because JCAM "routinely allocated" liquid, new issues to its credit opportunities fund, CrOp, despite having told investors that CrOp would invest solely in long-term, distressed, illiquid assets. JCAM agreed to pay approximately $2.5M to settle the SEC's charges.
- SEC Staff also has cited departure from stated investment objectives as a priority. In its 2019 Examination Priorities, OCIE pledged "to examine investment adviser portfolio recommendations to assess … whether investment or trading strategies of advisers are … contrary to, or have drifted from, disclosures to investors…."
- At a time when advisers are trying to stem fund losses, the temptation arises to adopt undisclosed trading strategies. This could amount to a violation of Advisers Act Section 206 even if the adviser does not realize it is following a previously undisclosed strategy.

Asset Valuation Especially Illiquid Assets

- Managers may be tempted to value illiquid Level 3 assets at their former market value, not reflecting current adverse market conditions.
  - As a result, manager may increase its management fee by increasing its AUM.
  - Even for managers not paid on a current AUM basis, manager may improve its reported performance.
- J. Kenneth Alderman, Inv. Co. Rel. No. 30300 (Dec. 10, 2012) (SEC charges eight outside directors of Morgan Keegan mutual funds for failure to establish effective valuation procedures or adequately to oversee valuations proposed by fund adviser for funds investing in sub-prime mortgage-backed securities during 2007-08 financial crisis).
- SEC v. Yorkville Advisors, LLC, No. 12-cv-7728 (S.D.N.Y. filed Oct. 17, 2012) (SEC alleges that adviser and two executives failed to follow stated valuation policies for valuing convertible securities, ignored negative valuation information, withheld adverse valuation information from auditors and misled investors about liquidity, collateral, and use of third-party valuation service, all to inflate firm's AUM, inflate management fees, and maintain positive performance record).
- KCAP Financial, Inc., Exch. Act Rel. No. 68307 (Nov. 28, 2012) (SEC charges BDC adviser and three executives for overvaluing CLOs and loans by failing to use evidence of contemporaneous transactions in those securities).

Parking Assets/Cross Trades to Remove Failing Assets from Troubled Funds

- Similar to prior point – managers may be tempted to engage in cross-trades between accounts, or “parking” trades with third parties.
  - Trades may be an attempt to validate the valuation of a security held by other accounts at the firm.
  - Trades may be an attempt to “window dress” portfolios to remove poor-performing securities or disguise variations from stated fund strategy prior to client reporting.
  - Trades may violate stated fund policies concerning cross-trades or other brokerage practices.
- SEC v. Commonwealth Advisors, Inc., No. 3:12-cv-00700 (M.D. La. filed Nov. 8, 2012) (investment adviser specializing in RMBS alleged to have made cross-trades at off-market prices benefitting some clients at the expense of others during 2007-08 financial crisis, and to have misled clients about valuation of, and valuation process for, mortgage-backed securities).
- SEC v. Allen, No. 05-453 (W.D. Pa. filed Apr. 6, 2005) (CEO and head of trading at fund manager allegedly engaged in “window dressing” trades at month-end to disguise fact that fund was taking on greater-than-disclosed levels of risk in the fund intra-month).

OUTGROWTH OF PUBLIC COMPANY DEVELOPMENTS

MNPI

- On March 23, 2020, the SEC's Co-Enforcement Directors, Stephanie Avakian and Steven Peikin, released a statement regarding the importance of maintaining market integrity, particularly with regard to MNPI, during the COVID-19 pandemic and its aftermath.
  - The statement warned that given the current, fast-evolving circumstances:
    - Corporate insiders' access to MNPI has likely increased
    - MNPI may have heightened value due to market volatility
    - The above conditions may be exacerbated by COVID-19 induced disclosure delays
  - The statement emphasized that individuals with access to MNPI must remain "mindful of their obligations to keep [MNPI] confidential and to comply with the prohibitions on illegal securities trading."
  - The SEC also cautioned public companies, broker-dealers, and investment advisers to ensure they remain in compliance with securities laws and regulations, and internal policies and procedures "designed to prevent the misuse of [MNPI]."
- Beyond the SEC's statement, stress on fund performance creates temptation to look the other way on MNPI, or make problematic judgment calls on restricted list placement or determinations of materiality.

Focus on Gifts and Entertainment to Advisers

- Perquisite Review. Although not announced, we understand that certain SEC enforcement staff may be conducting a sweep into perquisite disclosure practices by public companies.
  - Issue: Are public companies properly disclosing in proxy statements, as required under Item 402 of Regulation S-K, perquisites provided to senior management.
  - Especially when shareholders are suffering losses due to declining stock value, perquisite issues such as these have an optical and political appeal from an enforcement perspective.

  Application to the Adviser Context:

  - We envision that this public company focus could extend to a focus on fund payment of adviser expenses inconsistent with fund disclosures. The SEC has brought cases involving advisers that improperly charged adviser personnel entertainment to the fund. See, e.g., Blackstreet Capital Mgmt., LLC, Exch. Act. Rel. No. 77959 (June 1, 2016) (finding that the adviser to two private equity funds between 2010 and 2013 improperly charged each fund with one-third of the cost of the lease of a luxury suite at a D.C. arena, and related event tickets, without prior disclosure or approval).
  - We also envision that this could prompt a focus on executing broker entertainment of fund personnel. Approximately 15 years ago, the SEC brought cases involving executing broker entertainment of portfolio managers. See Kevin W. Quinn, Exch. Act Rel. No. 54862 (Dec. 1, 2006).

WHAT INDICIA WILL THE SEC EXAM AND ENFORCEMENT STAFF LOOK FOR AS RED FLAGS?

Unusual or Disparate Performance

- SEC closely examined managers who experienced exceptionally good performance in the 2008–2009 period.
  - See, e.g., SEC v. Balboa, No. 11-cv-8731, 2015 WL 4092328 (S.D.N.Y. July 6, 2015); SEC v. Kapur, No. 11 Civ. 8094, 2012 WL 5964389 (S.D.N.Y. Nov. 29, 2012).
- SEC has the National Exam Analytics Tool (NEAT), which enables OCIE examiners to access and systematically analyze years of trading data much more efficiently than in the past.
- We anticipate the SEC will use NEAT to focus on managers whose funds have experienced unusual or disparate performance (relative to prior performance of performance of peers) during recent periods of volatility.
- Managers should be careful to document in real time the basis for outsized performance in order to have a good record to present to the Staff upon exam.

Imposition of Gates and Suspensions

- Gates
  - Many funds provide for automatic imposition of gates if certain liquidity thresholds are met (either at the fund or investor level).
  - Managers should be careful to apply the gate provisions strictly in accordance with relevant disclosures – any waivers will be very carefully examined, especially if it results in remaining investors being unduly concentrated in illiquid positions.
  - In particular, waivers of investor level gates (which always expose a manager to risk of preferential treatment of investors) are highly inadvisable under current market conditions.
- Suspensions
  - Decisions to suspend redemptions, calculation of NAV and/or payments of redemption proceeds must be well documented in real time in consultation between the investment team, legal and compliance.
  - Be careful to follow corporate guidelines for when suspension must be effectuated – failure to formalize the suspension before a redemption date will open you up to challenge.
  - Managers should seek to focus on objective factors in deciding whether to suspend (e.g., illiquidity or highly limited liquidity in particular markets in which the fund's assets are traded) – this helps to support the record ***when (not if)*** the decision is challenged by investors or regulators.
  - Reliance on subjective factors (i.e., that suspension is "in the best interest of continuing investors") will require a clear record and is likely going to be closely scrutinized by investors (and their litigators) as well as regulators.

Valuation Challenges (e.g., Inability to Obtain Reasonably Consistent Marks)

- Investment teams need to review the valuation policies and ensure they still “work” in a more volatile environment.
  - Does the valuation policy for Level 2 assets have a protocol when there is material divergences between pricing provided by multiple brokers?
  - What is the default if the policy generally requires multiple marks but only a single mark can be obtained?
  - Who has to review deviations from the policy? Is that person (or committee) properly resourced when they have to increase the number of reviews?
- Often the policies allow for subjective adjustments by the manager.
  - While this is often useful operationally when pricing deviates materially from expectations, managers should proceed with caution.
  - There is no “one-size-fits-all” solution – the SEC has sanctioned managers for both over-valuing and under-valuing portfolio positions.

Changes in Disclosure Practices, including Selective Disclosure

- Additional Disclosures
  - Investors will ask for – or investment and IR teams may want to provide – more frequent and detailed disclosure about performance, portfolio construction, etc.
  - Need to be careful about setting expectations – if a manager that has generally provided high-level reporting on a monthly basis shifts (even temporarily) to more frequent (or more detailed) reporting, the manager is shifting the reliance standard. Investors can reasonably say they intend to start relying on that more frequent reporting, which can materially increase operational burdens.
- Selective Disclosure
  - While this is always risky, many managers get comfortable responding to individual requests.
  - Need to be extra-cautious in the current environment – the starting assumption should be that even if only one investor has asked for certain disclosure, that disclosure should be provided to everyone.
  - See, e.g., Lawrence D. Polizzotto, Exch. Act. Rel. No. 70337 (Sept. 6, 2013).
- Improved Processes
  - Investors are dealing with operational challenges.
  - Managers should strongly consider using web-based portals where access to disclosures can be provided in real time and not rely on sending out notices to e-mails or other addresses.

Back Up Resources

- Is there redundancy?
  - Most managers have very lean staffs and rely on external service providers that themselves are leanly staffed
  - Managers should closely examine all of their internal and external resources to make sure they are comfortable that there is sufficient redundancy when a particular person is taken offline by COVID-19 (i.e., the person is themselves ill or is required to take off time to deal with family medical issues)
- What about the “key person”?
  - Many “key person” provisions include inability to perform services for a period of time
  - The implications of a “key person” being ill need to be assessed in the harsh light of the current environment – most of these provisions were agreed to when no one thought they would come into play
  - Is there anyone who can realistically step in for a key person? If not, need to consider updating disclosures.

OPERATIONAL AND COMPLIANCE

Cyber (Especially for Remote Access) and Potential Security Issues

- Mandatory “stay-at-home” orders have required fund managers to rely on technology and the internet to facilitate remote work, increasing exposure to cybercrime (e.g., hacking, phishing, ransomware, malware and software vulnerability).
- On March 25, the SEC issued guidance on cybersecurity protocols and disclosure with respect to the effects and risks of COVID-19 on companies’ businesses, financial condition and results of operations.
- On April 8, the U.S. Department of Homeland Security Cybersecurity and Infrastructure Security Agency (CISA) and the U.K. National Cyber Security Centre (NCSC) issued a joint alert regarding COVID-19-related cybercrime, including a non-exhaustive list of warning signs and mitigation advice.
- On April 22, the SEC’s Office of Investment Education and Advocacy updated “Look Out for Coronavirus-Related Investment Scams – Investor Alert,” warning investors about internet fraudsters that claim that their products or services can prevent, detect, or cure coronavirus, and that the stock of their companies will dramatically increase in value as a result.
- Specific areas of vulnerability, particularly relating to remote access, include:
  - Non-secure remote meetings, conference calls or virtual classrooms
  - Opening attachments or clicking links within emails from unrecognized senders
  - Failure to update operating systems and software with latest patches and firewalls
  - Inadequate implementation or supervision of cybersecurity policies and procedures

BCP, Particularly "Real Time" Adjustments Necessitated by the Ongoing Nature of the COVID-19 Pandemic

"We are focused on ensuring that the business continuity plans of market participants are adjusted, as necessary or appropriate, to comply with health and safety measures, and that they also facilitate the continuing operation of our markets, market integrity and investor protection." – *SEC Chairman Jay Clayton, "Statement on the SEC's Coronavirus Response Efforts – Facilitating the Continued Orderly Operation of Our Capital Markets Consistent with Health and Safety Directives and Other Measures" (March 20, 2020)*

- Recently, in the context of ongoing exams, OCIE staff has included both oral and written requests for information specifically focused on registrants' preparedness in light of COVID-19. Sample questions include:
  - Does the firm have a Pandemic Continuity of Operations Plan?
  - Describe some of the aspects of the firm's BCP that are particularly applicable to maintain continuity of business operations when dealing with the COVID-19 epidemic.
  - Has the firm encountered any limitations in its ability to operate critical systems or operations with its personnel working remotely?
  - Has the firm considered assessing the impact of COVID-19 on its business and operations? If so, when does the firm believe it will undergo this assessment?
- OCIE staff also expects that registrants will conduct pandemic-related assessments of its third party service providers

Regulation Best Interest/Form CRS Compliance

- Form CRS and Regulation Best Interest (Reg BI) adopted in June 2019, with a compliance date of June 30, 2020.
- On April 2, 2020, SEC Chairman Clayton announced there will be no extension of this compliance date, despite implementation difficulties caused by COVID-19 crisis.
- Form CRS must be delivered both to retail investment advisory clients and broker-dealer clients prior to or at the opening of an account – and retail clients includes any natural person, no matter how wealthy or sophisticated.
- Reg BI only applies to broker-dealers, and requires that any recommendation of a security or an investment strategy to a retail client (same broad definition) be made in the best interest of the client, without regard for the firm's financial interest.
  - Applies to recommendations made by distributor broker-dealers affiliated with a private fund adviser.
  - Also applies to recommendations made by third-party broker-dealers that distribute private funds.
  - Existence of a "recommendation" is a facts-and-circumstances determination, but is broadly construed.
- The SEC and FINRA have stated compliance with Form CRS and Reg BI will be an exam priority.

Questions

Speaker Biographies

W. HARDY CALLCOTT
Partner
San Francisco
+1 415 772 7402
hcallcott@sidley.com

HARDY CALLCOTT's practice concentrates on enforcement defense and regulatory counseling concerning securities market and regulatory issues for broker-dealers, investment advisers, mutual funds and others in the financial services industry. He provides securities enforcement defense before the SEC, Department of Justice, FINRA and other SRO and state regulators for members of financial services industry, public companies and officers and directors. He also conducts internal investigations.

Hardy is a member of Sidley's global Securities Enforcement and Regulatory practice, which received the 2019 *Chambers USA* Award for "Financial Services Regulation Firm of the Year," and was named the "Law Firm of the Year" for Securities Regulation in 2020 and 2017 by *U.S. News – Best Lawyers*. He was ranked nationally in *Chambers USA* for Securities Financial Services Regulation 2008–2019 and included in *The Best Lawyers in America* 2007–2012 and 2014–2016 lists, chosen based on peer-reviewed surveys of U.S. lawyers. He was with Charles Schwab & Co. Inc., as senior vice president and general counsel. He served in the General Counsel's Office of the SEC as assistant general counsel for Market Regulation (now Trading and Markets), and taught in the Securities LLM program at Georgetown University Law Center. After law school, Hardy clerked for the Hon. Mariana Pfaelzer in the U.S. District Court for the Central District of California.

KEVIN J. CAMPION
Partner
Washington, D.C.
+1 202 736 8084
kcampion@sidley.com

KEVIN J. CAMPION advises a wide array of financial services firms including investment and commercial banks, broker-dealers and hedge funds — on a broad variety of regulatory, enforcement, compliance and transaction matters. Mr. Campion focuses his practice in particular on broker-dealer and market regulation matters, with particular emphasis upon regulations governing short sales (Regulation SHO), short interest reporting, Regulation M, research analyst conflicts, FINRA advertising rules, clearance and settlement, and broker-dealer registration and compliance issues. Mr. Campion also regularly assists advisers and hedge funds with trading questions and long and short position disclosure requirements, including the requirements of Section 13(d), 13(f) and Section 16. He also assists clients, mostly clearing firms and prime brokers, in the defense of U.S. Securities and Exchange Commission (SEC), FINRA, NYSE and state enforcement actions and investigations, as well as securities law class actions. Mr. Campion has represented the Securities Industry Financial Markets Association (SIFMA) with respect to comment letters submitted to the SEC, and in obtaining a variety of no-action letters from the SEC Staff relating to Regulation SHO and Rule 10a-1, including working with the SIFMA Prime Brokerage Committee on the new Prime Broker Letter.

Mr. Campion has been recognized annually in *Chambers USA: America's Leading Lawyers for Business* since 2011 in the area of Financial Services Regulation: Broker Dealer (Compliance; Nationwide).

BENSON R. COHEN
Partner
New York
+1 212 839 7317
brcohen@sidley.com

BENSON COHEN primarily represents investment advisers, broker-dealers and banks in connection with corporate, securities, MA and regulatory matters.

Benson has deep experience counseling asset management clients on the myriad regulatory structures applicable to their business, including the U.S. securities laws, ERISA, tax, FINRA, CFTC and NFA rules and regulations and the U.S. Bank Holding Company Act (including the Volcker Rule). Benson is well-versed in rules and regulations that affect institutional asset managers, start-up managers and participants in complex joint ventures. Clients laud Benson's ability to efficiently and effectively deliver legal services and manage teams. Clients cited his combination of comprehensive legal knowledge, attention to detail, clear communication style, responsiveness and a practical commercial perspective.

Benson has been recommended in Investment Fund Formation and Alternative/Hedge Funds in *The Legal 500 US* (2014–2017).

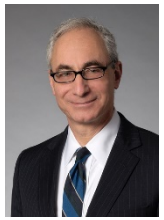
Benson works with public companies to maintain the confidentiality of information filed with the SEC.

Speaker Biographies (cont'd)

LAURIN BLUMENTHAL KLEIMAN
Partner
New York
+1 212 839 5525
lkleiman@sidley.com

LAURIN BLUMENTHAL KLEIMAN is a global co-leader of Sidley's Investment Funds practice team. She advises a wide range of domestic and international investment funds and managers on regulatory, compliance and enforcement issues. Laurie is a frequent speaker on investment manager and fund regulation and compliance as well as on issues relating to the advancement of women in law. Her practice encompasses advice to both U.S. and non-U.S. managers to investment products of all types — including hedge funds, mutual funds, private equity funds, real estate funds, collateral managers and managed accounts — with respect to both U.S. federal and state investment manager registration, regulation and compliance; organization and registration of U.S. registered investment companies, including mutual funds, money market funds and closed-end funds; advice to financial institutions with respect to investment fund and manager compliance and governance issues and fund and manager mergers, acquisitions and reorganizations; and assistance to investment managers in connection with SEC examinations.

Strong advocacy on behalf of her clients has earned Laurie acknowledgment in numerous industry publications, including *Best Lawyers in America* (2016–2020); *Chambers USA* (2010, 2016, 2020), where she is currently ranked as a Band 1 lawyer for her work in Investment Funds: Regulatory & Compliance; *Chambers Diversity* (2016); *The Legal 500 US* (2015–2017) and *U.S. News & World Report* (2016–2018).



BARRY W. RASHKOVER
Partner
New York
+1 212 839 5850
brashkover@sidley.com

BARRY RASHKOVER is one of two leaders of Sidley's global Securities Enforcement and Regulatory practice, which received the *Chambers USA* "Firm of the Year" awards in 2019 and 2016 for Financial Services and Securities Regulation, and which was named the "Law Firm of the Year" for Securities Regulation in 2020 and 2017 by *U.S. News – Best Lawyers*. He also co-heads the Firm's New York Regulatory and Enforcement Group. A former SEC senior official and veteran regulatory defense lawyer, he represents companies and individuals in enforcement matters brought by the Securities and Exchange Commission, Department of Justice, FINRA, Commodity Futures Trading Commission, and state attorneys general, among others. Described as an "A-team player" in Chambers USA, Barry counsels investment banks and other broker-dealers, investment advisers, public companies, accounting firms and senior officials. Before joining Sidley, Barry served as co-head of Enforcement and Associate Regional Director for the SEC's Northeast Regional Office, among other positions. Also a former SEC Senior Trial Counsel, Barry creates novel and effective strategies to coordinate the defense of regulatory investigations with parallel civil litigation and criminal cases.

Strong advocacy on behalf of Barry's clients has earned him acknowledgment in numerous industry publications, including *Chambers USA*, *U.S. News – Best Lawyers*® "Best Law Firms," *WWL Global Investigations Review*, *Benchmark Litigation* and *The Legal 500.*

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