Simpson Thacher

Regulatory and Enforcement Alert

Compliance Policies Update Hot Topics

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With Form ADV season in the rear view mirror, we recommend that sponsors turn to refreshing their compliance policies to align with rapidly evolving regulatory expectations. To that end, we provide a non-exhaustive list of hot topics to consider below, including with context from SEC examinations and SEC enforcement settlements.

- **Amended Marketing Rule**: Sponsors should ensure their policies and procedures are updated to reflect the amended Marketing Rule, including as interpreted by the staff's FAQs. The compliance deadline was November 4, 2022, and both the Division of Examinations and the Division of Enforcement have been testing compliance and aggressively investigating perceived inadequacies.
    - Examiners are testing how sponsors have updated their policies for the amended Marketing Rule and are also requesting production of evidence that relevant employees were trained on the amended Marketing Rule. Examiners are also substantively reviewing marketing materials for deficiencies. Yesterday, the Division of Examinations released its first substantive Risk Alert containing initial observations in connection with amended Marketing Rule compliance, including common deficiencies.
    - Enforcement has been active in pursuing amended Marketing Rule violations, announcing nine settlements in September 2023 and five more in April 2024 with a principal focus on unsupported hypothetical performance. The Enforcement sweep is ongoing.
- **Texting/Electronic Communications**: In light of the slew of SEC settlements involving off-channel communications since 2022, many sponsors have been evolving their electronic communications policies and procedures to include more precise definitions of covered communications, among other things. It is important for a sponsor's policies to align with actual practices and to continue to monitor employee adoption of new policies and technologies.
    - Examiners typically ask investment advisers a standard question about monitoring and review of communications related to the adviser's business; accordingly, advisers should be prepared to answer.
    - Notably, the SEC recently announced this month the first ever off-channel enforcement action involving an adviser to private funds; more broadly, virtually all enforcement investigations, irrespective of subject matter, now involve request for texts and other app-based communications such that record-keeping gaps–even if not the initial focus–can quickly come under the spotlight.
- **Pay-to-play**: Advisers should ensure their pay-to-play policies are best in class and clear, especially considering the draconian consequences for what may be an inadvertent foot fault.

- Examiners often ask for documentation pertaining to political contributions including pre-clearance requests. One Commissioner recently commented on the challenges with the pay-to-play rule, noting in her dissent to the enforcement action mentioned below: "To avoid questions from Commission examiners, the easiest course is not to contribute to political campaigns."
- Earlier this month, the SEC settled with an adviser for pay-to-play violations stemming from a one-time campaign contribution of $4,000. The settlement was silent on the adviser's policy requirements and there were no policy violations charged (Rule 206(4)-7 under the Advisers Act), so the implication is that the adviser had appropriate policies but that the policies were not followed. This underscores the importance of not only having a clear policy but also of periodically reminding (and potentially requiring attestations from) supervised persons of their compliance obligations.

- **MNPI**: Policies related to the prevention of insider trading and the appropriate handling of confidential business information are typically some of the most challenging policies to implement given the need for tailoring to a particular adviser's investment model, risks in information flows, and actual practices (*e.g.*, open architecture versus information barriers). While the SEC has traditionally viewed the handling of MNPI through an insider trading lens, there is an increasing trend in the examination and enforcement programs to view MNPI through a policy lens, thus broadening the risk of potential violations.
  - Examiners typically request various information regarding an adviser's processes for MNPI monitoring. It is critical for an adviser's policies to be updated consistent with any evolving practices and to account for the handling of MNPI received from portfolio companies including from board seats, limited partners, and other marketing participants.
  - The Division of Enforcement has settled several noteworthy MNPI cases in recent years. One settlement in May 2020 was with an adviser for solely policy and procedure related charges in connection with MNPI obtained by virtue of board seats. Another more recent settlement in December 2023 involved allegations that the adviser did not comply with its own policy requirement that disclosure of MNPI be limited to situations in which it was "necessary for legitimate business purposes"—this settlement underscores the need to ensure that policy matches practices and that investment professionals are broadly sensitized to the need for discretion in discussing MNPI.
- **Artificial Intelligence ("AI")**: As with any new technology or practice, a sponsor should ensure its policies evolve along with its practices.
  - Examiners are already testing sponsors' AI policies. Sponsors who use, or expect in the near term to use, AI should strongly consider adopting particularized AI policies.
  - The Division of Enforcement has launched its AI-related enforcement efforts with settlements involving allegations of "AI washing," which is a term the SEC uses to describe when statements about AI do not match actual practices (similar to the term "greenwashing" in the ESG space). These recent settlements involve fairly straightforward anti-fraud allegations, as well as marketing rule violations and policy violations.

In summary, this is an opportune moment for an adviser to ensure that its compliance policies and procedures are appropriately tailored to its business, particular risks, and actual practices. It is important for compliance policies to be expansive enough to cover relevant risks, but it is likewise important for compliance policies not to overstate practices and risk missteps on examination or in enforcement.

For further information regarding this memorandum, please contact one of the following authors:

WASHINGTON, D.C.

David W. Blass
+1-202-636-5863
david.blass@stblaw.com

Meaghan A. Kelly
+1-202-636-5542
mkelly@stblaw.com

NEW YORK CITY

Michael J. Osnato, Jr.
+1-212-455-3252
michael.osnato@stblaw.com