WINSTON & STRAWN LLP

CLIENT ALERT

Material Non-Public Information Risk Alert

MAY 9, 2022

On April 26, 2022, the Division of Examinations ("EXAMS") of the Securities and Exchange Commission ("SEC") released a Risk Alert ("Risk Alert")[1] relating to certain compliance issues observed by EXAMS that relate to the handling of material nonpublic information pursuant to Section 204A ("Section 204A") of the Investment Advisers Act of 1940, as amended (the "Advisers Act"), and Rule 204A-1 (the "Code of Ethics Rule") promulgated under the Advisers Act (the Code of Ethics Rule).

As noted in the Risk Alert, Section 204A requires registered and unregistered investment advisers to establish, maintain, and enforce written policies and procedures to prevent the misuse of material non-public information ("MNPI"). The Code of Ethics Rule requires investment advisers that are registered (or required to be registered) under the Advisers Act to adopt a code of ethics.

The Risk Alert serves as a useful roadmap of potential examination priorities and should be considered in connection with an investment adviser's review of its compliance program. EXAMS noted that "[d]eficiencies related to Section 204A and the Code of Ethics Rule have been among the most commonly observed by EXAMS."

Investment advisers should therefore review their practices, policies, and procedures as they relate to Section 204A and the Code of Ethics Rule and take steps to determine that they are in compliance with those requirements. Investment advisers should also attempt to ensure that their codes of ethics are reasonably designed to confirm such compliance, taking into account the nature of their businesses.

Section 204A

The Risk Alert discusses three general areas of conduct associated with Section 204A that were observed by EXAMS.

Policies and procedures related to Alternative Data. EXAMS staff observed investment advisers that made use of data from non-traditional sources (i.e., sources other than traditional financial statements, company filings, and press releases, such as satellite and drone imagery, social media and internet search data), but did not appear to adopt or implement reasonably designed written policies and procedures to address the potential risk of receipt and use of MNPI through such sources.

Such deficiencies include failure to adequately memorialize diligence processes; failure to adopt policies and procedures regarding the assessment of the terms or obligations related to the collection or provision of alternative data; and inconsistent implementation of policies and procedures relating to alternative data service providers.

Policies and procedures related to "value-add investors." EXAMS staff observed investment advisers that did not have or did not appear to implement adequate policies and procedures regarding investors or key persons that would be more likely to possess MNPI (e.g., officers or directors at a public company, principals of other asset management firms, and investment bankers).

These deficiencies include failure to adopt policies and procedures regarding MNPI risks posed by such "value-add investors"; and failure to correctly identify all of such persons or correctly identify and track such persons' sources of MNPI.

Policies and procedures related to "expert networks." EXAMS staff observed investment advisers that did not appear to have or did not appear to implement adequate policies and procedures regarding their use of expert network consultants.

Such deficiencies include failure to track and memorialize calls with expert network consultants; failure to review notes from expert network calls; and failure to review trading activity of supervised persons in the securities of issuers in similar industries as those discussed during expert network consultant calls.

Code of Ethics Rule

The Risk Alert discusses four general areas of conduct associated with the Code of Ethics Rule that were observed by EXAMS.

Identification of access persons. EXAMS staff observed that some investment advisers did not adequately identify and supervise access persons in accordance with the Code of Ethics Rule.

Access persons did not obtain required pre-approval for certain investments. EXAMS staff observed that some investment adviser access persons purchased interests in initial public offerings and limited offerings without requisite pre-approval, and some investment advisers did not include provisions in their codes of ethics requiring such pre-approval.

Personal Securities Transactions and Holdings. EXAMS staff noted certain deficiencies related to access persons' personal securities transactions and holdings reporting obligations. Such deficiencies included an inability to produce evidence of supervisory review of holdings and transaction reports; failure to adopt policies and procedures to assign the Chief Compliance Officer's reporting to another member of the adviser; failure of access persons to submit required reports; failure of investment advisers to include reporting obligations for access persons in the investment advisers' codes of ethics; untimely submission of reports; and codes of ethics that failed to require access persons to provide specified content set out by the Code of Ethics Rule in their transaction and holdings reports, including instances in which access persons did not include their investments in private placements.

Written acknowledgement of receipt of the code and any amendments. EXAMS staff observed instances where supervised persons were not provided with a copy of the investment advisers' codes of ethics; failure of supervised persons to provide written acknowledgement of their receipt of the code of ethics or any amendments thereto; and failure of investment advisers to include a requirement for supervised persons to provide written acknowledgment of receipt of the code of ethics and any amendments thereto.

Finally, the Risk Alert noted that investment advisers should consider the following in crafting their codes of ethics and tailoring their compliance policies and procedures:

Trading investments on restricted list. Incorporating provisions relating to "restricted lists" of issuers about which the investment adviser has inside information, and prohibiting any trading in securities of issuers on such restricted lists.

Allocation of investment opportunities. Incorporating procedures to confirm that investment opportunities must first be offered to clients before the investment adviser and its employees may act on them.

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We can be available at your convenience to discuss the matters addressed in the Risk Alert, as well as the ways such matters may affect your business.

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[1] EXAMS's Risk Alert is available at https://www.sec.gov/files/code-ethics-risk-alert.pdf.

4 Min Read

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