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Private Equity Regulatory Update - May 2023

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In this issue, we discuss an SEC Examinations Division risk alert on LIBOR-transition preparedness, and recent remarks of SEC Director Birdthistle regarding developments in the asset management industry.

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Rules and regulations

SEC adopts amendments to bolster private fund reporting

The SEC's amendments to Form PF include new event reporting requirements for large hedge fund advisers within 72 hours of the occurrence of certain events, and for private equity fund advisers within 60 days of the fiscal quarter end; and revised reporting requirements for large private equity fund advisers. Please see our recent client update for more information on this topic.

NY Attorney General seeks broad authority over digital assets

The NY Attorney General is seeking legislation that would significantly expand the state's reach over digital assets and require wholesale changes to the operation of digital asset businesses that choose to remain in New York. Please see our recent client update for more information on this topic.

Industry update

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SEC Examinations Division issues risk alert on observations from examinations of investment advisers and investment companies concerning LIBOR-transition preparedness

On May 11, 2023, the Division of Examinations (Examinations Division) issued a risk alert on its observations from examinations relating to the preparedness of registered investment advisers and investment companies (firms) for the anticipated discontinuation of the London Interbank Offered Rate (LIBOR). Firms examined by the Examinations Division included: (i) advisers associated with large bank complexes; (ii) advisers to various types of registered investment companies (i.e., mutual funds, closed-end funds, exchange-traded funds, and business development companies); (iii) small, medium and large fund complexes; (iv) advisers to private funds that invest in private credit, such as collateralized loan obligations; and (v) large retail-oriented advisers. The Examinations Division had the following observations:

- **Risk management**: Examinations Division staff observed that firms with significant LIBOR exposure generally treated the LIBOR transition as an enterprise risk governance matter, and formed cross-functional working groups overseen by risk governance committees, created detailed transition plans and completed comprehensive impact assessments on investment and operational exposures. Almost all firms examined by the staff were either members of the Alternative Reference Rates Committee (ARRC) or relied on its guidance. The staff observed that firms have also taken steps to ensure that relevant personnel are kept informed about the LIBOR transition and any internal policies, procedures or guidance.
- **Operations**: The staff noted that firms have worked with service providers, sub-advisers and third-party managers to assess their transition readiness and performed end-to-end testing to confirm that their internal systems can accommodate alternative reference rates (ARRs).
- **Portfolio management**: The staff observed that many firms have adopted a global approach to identifying LIBOR exposure, looking across subsidiaries and affiliates. Most firms utilized internal tools to track and monitor LIBOR and ARR exposure on a real-time or periodic basis. The staff noted that many firms used third-party service providers to review LIBOR-linked contracts and identify fallback provisions, or the lack thereof.
- **Fiduciary responsibilities and investor communications**: The staff observed that firms with large direct client exposure addressed their fiduciary obligations by remediating contracts, while firms with indirect exposure have conducted due diligence on third-party fund managers' transition readiness. The staff noted that firms have examined conflicts of interest related to the transition, such as cross-trading, principal transactions, allocation of transition costs and clients with conflicting priorities. The staff observed that firms with significant LIBOR exposure have provided comprehensive disclosure on the risks associated with the transition, such as legal, operational, credit and regulatory risks. The staff also observed that firms utilized a wide range of client communication methods, depending on their businesses and determinations of the level of information that would be relevant for clients.
- **Keeping informed about ongoing and new challenges**: The staff noted that firms have generally stayed informed about the ongoing and new challenges of the transition, and highlighted the following:
  - "**Transitioning bank loans in advance of June 30, 2023.** The ARRC has encouraged market participants to remediate as many outstanding LIBOR-linked bank loans as practicable before the cessation date, to avoid a flood of contracts requiring individually negotiated amendments in mid-2023."
  - "**Complex contracts and synthetic LIBOR.** A few complexes identified highly complex LIBOR-linked contracts that: (i) are issued overseas and not subject to the Adjustable Interest Rate (LIBOR) Act of 2021, and (ii) where no fallback language exists and/or transition via an amendment process is impracticable. It is likely that many of these contracts will now transition to a synthetic LIBOR."
  - "**Operational challenges associated with June 30, 2023 cessation date.** Firms noted significant operational

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complexities associated with the conversion of LIBOR-linked contracts that will be transitioning, whether by hardwired fallback provisions, an amendment process, or the LIBOR Act for legacy contracts with no or impracticable fallback provisions (tough legacy). Firms recommended continued monitoring of the ARRC and other industry resources for guidance and tools in addressing these complexities."

The Examinations Division concluded by reminding firms to be aware of the challenges that exist to a smooth and orderly transition away from LIBOR and encouraging them to act in accordance with their fiduciary obligations throughout the transition process.

SEC Director Birdthistle delivers remarks regarding recent developments in the asset management industry

On March 20, 2023, William Birdthistle, Director of the Division of Investment Management (the Division) of the U.S. Securities and Exchange Commission (the SEC), delivered remarks at the ICI Investment Management Conference, emphasizing that recent technological advancements in the asset management industry, demographic changes in the United States and abroad and rapid market growth may present new challenges to advisers' obligations under securities laws.

Technological Advancements and Cybersecurity:

Director Birdthistle noted that the Division is devoting increased attention to examining asset managers' responsibilities in light of recent technological developments, with a view to the following areas:

- *Enhanced Reporting of Cybersecurity and Data Privacy Incidents:* Director Birdthistle suggested that last year's proposed rules and amendments under the Investment Advisers Act of 1940 (the Advisers Act) with respect to cybersecurity risk management and cybersecurity-related disclosure for registered investment advisers (RIAs) and funds could "serve as a significant step" toward addressing new technology-related challenges facing the asset management industry. In particular, he highlighted that the proposed rules and amendments would require RIAs and funds to take steps to mitigate and disclose cybersecurity risks, to enhance adviser and fund disclosures of cybersecurity incidents and to report significant cybersecurity incidents to the SEC.
- *Proposed Amendments to Regulation S-P:* Director Birdthistle also added that the SEC's March 15, 2023 proposal to amend Regulation S-P is designed to minimize risks of unauthorized access to or use of personal information. In particular, he suggested that the proposal, if adopted, would respond to these threats by requiring broker-dealers, RIAs and registered investment companies to adopt written policies and procedures for incident response programs that address unauthorized access to or use of customer information, and include procedures for notifying persons affected by such an incident within 30 days.
- *Proposed Amendments to the Investment Adviser Custody Rule:* Director Birdthistle also commented that recent technological developments, including the use of blockchain technologies to record ownership and transfer assets, prompted the SEC's February 15, 2023 proposal to amend the custody rule under the Advisers Act.

Demographic Changes:

Director Birdthistle also noted that changing demographics in the United States and abroad, including the expected wave of retirements in the near future and changing demographic trends within the asset management industry itself, may warrant the Division's focus to ensure that investors receive the "highest quality disclosure available" to make informed investment decisions. Director Birdthistle highlighted the SEC's response to these impending demographic changes in the following areas:

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- *Annual and Semi-Annual Shareholder Reports Provided (Mutual Funds and ETFs):* Director Birdthistle cited the SEC's adoption in October 2022 of amendments to the requirements for annual and semi-annual shareholder reports provided by mutual funds and exchange-traded funds (ETFs). In particular, he emphasized that these reports will now be significantly shorter, will highlight key information and will facilitate comparisons among different products.
- *Proposed Amendments to the Names Rule under the Investment Company Act of 1940 (the Names Rule)*: Director Birdthistle noted that the SEC's proposed amendments to the Names Rule are designed to address the evolution of naming practices in the fund industry. In particular, to enhance alignment between the marketing benefits associated with a particular fund name and investors' expectations, Director Birdthistle highlighted that the proposed amendments would extend the 80% investment policy requirement to "any fund name with terms suggesting that the fund focuses in investments that have (or whose issuers have) particular characteristics."
- *Diversity Self-Assessments:* Director Birdthistle noted that the response rate to SEC's Office of Minority and Women Inclusion's request for voluntary self-assessments of investment advisers' diversity policies and practices was "disappointingly low." Relatedly, he cited the Division's recent publication of a Staff FAQ on investment adviser consideration of DEI Factors, which explained that an investment adviser may consider DEI factors when recommending other investment advisers to, or selecting other investment advisers for, its clients under its fiduciary duty.

Rapid Market Growth:

Director Birdthistle also noted that the rapid growth in the market overall and the number and type of underlying products may present new challenges for investment advisers and the funds that they manage. He added that increasing competitive pressures in the asset management industry may encourage advisers to seek cost efficiencies, including:

- *Outsourcing Advisory Services to Third-Party Service Providers*: Director Birdthistle expressed concern over investment advisers outsourcing advisory services to, or sharing investors' personal information with, third-party service providers without adequate oversight or disclosures to investors. Specifically, he identified a heightened risk of client harm when, without appropriate regulatory oversight, an adviser outsources functions to service providers that are highly technical, proprietary to the service provider or otherwise necessary to its provision of advisory services. Director Birdthistle described the proposed new Rule 206(4)-11 and related amendments under the Advisers Act (the Proposed Outsourcing Rule) as responsive to this trend. The Proposed Outsourcing Rule would require RIAs to conduct due diligence of third-party service providers and impose ongoing monitoring obligations on them, which Director Birdthistle characterizes as furthering investor protections by enhancing RIAs' oversight of such service providers.

Litigation

SEC charges adviser and principal for breaches of fiduciary duty relating to investment of client funds in leveraged ETFs

On May 4, 2023, the SEC issued an order (the CAM Order) instituting and settling cease-and-desist proceedings against Classic Asset Management LLC (Classic), a North Dakota-based adviser, and its part-owner, Douglas Schmitz, arising out of alleged breaches of fiduciary duty relating to investments in leveraged ETFs.

According to the CAM Order, from January 2017 through December 2020, Classic and Schmitz purchased and held leveraged ETFs in advisory client accounts. The Order notes that the prospectus for such leveraged ETFs warned that

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those funds' returns for periods longer than a single day will likely differ in amount and direction from the funds' stated index for the same period, and that, for periods longer than a single day, the fund would lose money if the relevant index's performance was flat, and possibly even if the index rises.

Despite these warnings, the SEC alleges, Classic and Schmitz invested roughly 76% of the clients Schmitz advised in leveraged ETFs, and that leveraged ETFs comprised roughly 56% of the total market value in client accounts he advised as of December 31, 2019. These client accounts also allegedly held positions in leveraged ETFs for extended periods—90% were alleged to be held for more than 100 days. These accounts experienced substantial losses, allegedly on account of the holdings in leveraged ETFs.

The SEC further alleges that neither Schmitz nor Classic "had a reasonable basis" to conclude that leveraged ETFs were suitable for their clients; Schmitz and Classic also allegedly failed to monitor these investments.

On account of these violations, Schmitz and Classic are alleged to have violated Section 206(2) of the Advisers Act, and Classic is alleged to have violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which require advisers to adopt and implement procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder.

Schmitz and Classic agreed to cease and desist from future violations, and to be censured. Classic agreed to pay disgorgement of $81,824, prejudgment interest of $13,404, and a civil money penalty of $100,000; Schmitz agreed to pay disgorgement of $523,086, prejudgment interest of $115,027, and a civil money penalty of $100,000.

In connection with the CAM Order, Commissioners Crenshaw and Lizárraga issued a statement noting that "[t]his misconduct serves as an important reminder that complex exchange-traded products pose complex risks" and that "previous Commissions have been highlighting these investor protection issues for some time now." They further opined that "[c]omplex products, such as leveraged or inverse products that are designed primarily as short-term trading tools for sophisticated investors are unlikely to be in the best interest of a retail investor absent an identified, short-term, investor-specific trading objective."

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