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SEC Risk Alert Focuses on Potential Deficiencies Regarding Use and Monitoring of Material Non-Public Information

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On April 26, 2022, the Securities and Exchange Commission's Division of Exams ("EXAMS") published a Risk Alert entitled "Investment Adviser MNPI Compliance Issues" focused primarily on investment advisers' use of material non-public information ("MNPI") and policies/procedures relating thereto.

Use of Alternative Data

The EXAMS staff Risk Alert highlighted for the first time deficiencies and weaknesses related to alternative data policies. "Alternative data" is defined as data from non-traditional sources increasingly used in financial analysis, such as social media and internet search data, satellite and drone imagery, analyses of aggregate credit card transactions, and email data obtained from apps and tools that consumers may utilize. EXAMS staff reminded advisers to:

- Adequately memorialize diligence processes of alternative data service providers and consistently apply and document that process; and
- Implement policies and procedures to assess any legal or other obligations related to the collection or provision of alternative data.

Other Recent SEC Guidance on MNPI

Many of the other issues raised by the EXAMS staff have been on the SEC's radar for quite some time. Previously, on June 30, 2020, the SEC issued a risk alert that highlighted its observations of commonly encountered deficiencies from its examinations of private fund advisers, which included the kinds of conflicts of interest disclosures and MNPI policy issues now highlighted as reminders in this new Risk Alert.

A Reminder Regarding Code of Ethics Requirements

Section 204A of the Advisers Act requires that advisers establish and maintain written policies and procedures to prevent misuse of MNPI. Relatedly, Rule 204A-1 under the Advisers Act obligates advisers to establish standards of conduct for advisory personnel and resolve conflicts raised by their personal trading. Despite these rules and the significant risks associated with misuse of MNPI, the SEC frequently and again in this Risk Alert identified general failures in policies and procedures addressing such risks. For example, EXAMS cited policies and procedures that fail to address (1) insider trading risks posed by

employees interacting with people with access to MNPI, such as public company insiders, consultants retained through “expert networks,” and “value-added investors,” including lack of documentation for communications with those “insiders”; (2) identification, pre-approval, and holdings and transactions reports for “access persons”; and (3) lack of specificity with restricted trading lists.

Common Deficiencies Relating to Access Persons¹

EXAMS staff highlighted deficiencies related to the identification of and approval for certain investments by “access persons,” namely that:

Identification of Access Persons – Policies should define “access person” and require the identification and supervision of these individuals;

Investment Pre-Approval for Access Persons – Policies should require pre-approval for certain investments by access persons, including any direct or indirect acquisition of interests in an initial public offering or limited offering; and

Review and Retention of Holdings and Transaction Reports for Access Persons – Policies should require the submission of holdings and transaction reports by access persons, including specific content requirement (e.g., disclosure of investments in private placements) and supervisory review of holdings and transaction reports for access persons.

Restricted Lists and Allocation Policies

EXAMS staff identified potentially inadequate policies and procedures around advisers’ restricted trading lists, specifically the failure to incorporate provisions that specifically include “restricted lists” of issuers about which the advisory firm has inside information. Policies related to restricted trading should have sufficient specificity regarding the timeline for any prohibition on trading in securities of issuers on the “restricted lists,” the internal process for adding and removing securities from the restricted trading list, and procedures to identify and enforce trading restrictions based on this list.

In addition, EXAMS staff raised concerns regarding the allocation of investment opportunities by advisers. The SEC has previously noted deficiencies in disclosures regarding the allocation of investment opportunities among client fund vehicles and accounts, including flagship funds and co-investment vehicles. Deficiencies included inconsistent application of allocation policies, preferential allocations of limited investment opportunities to proprietary accounts, clients paying higher fees without adequate disclosure, and preferential allocations of limited opportunities to new accounts without adequate disclosure. In this Risk Alert, EXAMS staff is highlighting the need for specific procedures to ensure that investment opportunities are first offered to clients before the adviser or its employees may act on those opportunities.

Next Steps for Private Fund Advisers

Private Fund Advisers should carefully evaluate their policies and procedures to ensure that they are consistent with the positions described in the Risk Alert. While the Risk Alert focuses on SEC-registered investment advisers, which are subject to routine examination by the SEC, it also notes that certain of the deficiencies fall under Section 206 of the Investment Advisers Act of 1940, which applies equally to registered investment advisers and to exempt reporting advisers.

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¹ “Access persons” are any supervised persons who have access to non-public information regarding client transactions or reportable fund holdings, make securities recommendations to clients, or have access to such recommendations that are non-public, and, for most advisers, all officers, directors, and partners.

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