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WELLS FARGO SECURITIES

Wells Fargo Prime Services Business Consulting

Industry and Regulatory Updates

Highlights

Industry Trends

Mainland China and Singapore Markets Opening Up for Hedge Fund Managers

By: Alice Huang and Cindy Pan, Partners at Morgan, Lewis & Bockius; and Joel Seow, Partner at Morgan Lewis Stamford LLC

Fund managers with trading strategies focusing on the key financial markets such as mainland China, Hong Kong, Japan, and Singapore historically have set up operations in Hong Kong to access the various financial markets in Asia. With increasing liberalization of the China domestic financial services market to foreign players and Singapore's ongoing efforts to be the leading asset management hub for Asia, recent regulatory changes in mainland China and Singapore have aimed at attracting capital and talent onshore by providing clearer regulatory regimes and more flexible structuring options.

Mainland China Opening Up Financial Services Market

Under the current regulatory framework of the People's Republic of China (PRC), multiple entry schemes are now available for global hedge fund managers' access to the China market:

1. Offshore Investment into China

PRC laws allow foreign hedge fund managers to invest in China securities and bond market through various schemes which would not trigger the requirement to establish a presence within mainland China. Such market entry schemes include:

- Qualified Foreign Institutional Investor (QFII) and Renminbi Qualified Foreign Institutional Investor (RQFII)
- Stock Connect
- Direct Access to China Interbank Bond Market (CIBM)
- Bond Connect

Since the beginning of 2019, regulators in China have announced a number of measures to facilitate foreign investments through the above schemes, such as removing the limitation of investment quota under the QFII and RQFII regimes.

2. Access to the China Securities & Bond Market Through Establishment of a Presence in China - Private Securities Fund Manager

Since 2017, China has committed to further opening up its financial services industry to foreign investors. Foreign hedge fund managers can now establish a wholly foreign-owned enterprise (WFOE) and apply for a license to engage in private securities fund management business in mainland China (commonly referred to as the PFM license). With such PFM license, the WFOE can offer investment fund products denominated in RMB to qualified investors in China and use such funds to invest in China securities and bond market. According to the data published by the Asset Management Association of China (AMAC), as of October 2019, 22 WFOEs established by international fund managers have successfully obtained the PFM license to engage in private securities fund management business (including those established by well-known global hedge fund managers from the United States) and 57 RMB fund products have been raised.

3. Raising Funds from Chinese Investors to Invest in Offshore Products

In addition to the above-mentioned schemes, some local governments have launched certain pilot programs, including Qualified Domestic Limited Partner (QDLP) in Shanghai and Qualified Domestic Investment Enterprise (QDIE) in Shenzhen, which allow reputable foreign hedge fund managers to establish a foreign-invested fund management company within the jurisdiction of the pilot program to raise RMB from domestic qualified investors to invest in such foreign hedge fund managers' offshore products. However, such outbound-oriented programs will always be subject to the overarching foreign exchange control policy of China.

New Kid in Town – Singapore Variable Capital Company (VCC)

The VCC is a new Singapore corporate structure that is tailored for use by investment funds, otherwise known as "collective investment schemes" in Singapore. Intended to complement existing fund structures available for use in Singapore (principally the unit trust and limited partnership), it comes as no surprise that the VCC has been widely discussed in the alternative asset space.

The following are the key features of the VCC:

1. Purpose: The VCC can accommodate both open-ended and closed-ended funds, and can also take the form of an umbrella structure consisting of multiple sub-funds pursuing different investment strategies.
2. Capital Issues: VCCs are allowed to redeem shares and pay dividends from their share capital, unlike Singapore private companies which are subject to strict capital maintenance rules.
3. Re-domiciliation: Managers of foreign corporate fund entities may re-domicile their foreign structures into Singapore as VCCs.
4. Ring-fencing: The assets and liabilities of sub-funds in an umbrella VCC are segregated. Assets of one sub-fund may not be used to discharge liabilities of the VCC or any other sub-funds.
5. Tax-incentives: The VCC will be treated as a single entity for income tax purposes and can rely on Singapore's extensive tax treaty network with other jurisdictions.

With the VCC's attractiveness and the traditional advantages of Singapore (primarily its pro-business environment and developed infrastructure), we have seen strong interest in the VCC from regional and global fund managers pending its launch which is anticipated to be during Q1 of 2020. While it remains to be seen whether the VCC will take off, its growing traction suggests Singapore is perhaps one step closer to establishing itself as a full-service international fund management hub alongside other global fund domiciles

GIPS Compliance

By: Shivani Choudhary, Senior Principal Consultant, ACA Performance Services

Today we are seeing a noticeable shift towards hedge fund managers inquiring about GIPS compliance. We believe the trend towards GIPS compliance across the hedge fund space will continue to grow as investors and allocators continue to request and require GIPS compliance from competing managers.

One of the major initiatives of the 2020 edition of the GIPS® Standards was to make compliance easier for alternative managers. In the past, it did not make sense for many of alternative managers to claim GIPS compliance due to the absence of composites at such firms. However, given the lack of standardization of investment performance reporting in the alternative manager universe, and the new, more flexible structure of the GIPS standards, compliance may be an attractive option for firms looking for consistency. Additionally, as investors demand more transparency into investment performance, we see adoption of the GIPS standards as a very real possibility for many alternative managers that may have never considered doing so.

Institutional investors have historically requested that traditional managers claim GIPS compliance, going as far as eliminating potential managers from consideration for failing to do so. We have seen through RFP data recently that this trend is starting to emerge within the alternative investment space as well and should continue with the transition to the 2020 GIPS Standards.

The goal of the GIPS standards is to promote full disclosure and fair representation of performance results in an apples-to-apples format so that prospective investors get a consistent view of performance from one manager to another. The 2020 GIPS standards should be appealing to alternative investment managers for the following reasons (among others).

- Vehicle Based Reporting: The 2020 GIPS Standards enable firms to present performance in line with how a strategy is being marketed. For separate account strategies, marketing efforts are composite based, while private funds employ a vehicle-based approach.
- Carve-Outs with Allocated Cash: In addition, the 2020 GIPS Standards allow for carve-out performance to be utilized as a way to represent a new strategy. This can be a useful tool for firms wishing to create a new fund based off a particular vertical within an existing fund. There are specific rules detailing how this carved-out information must be presented.
- Additional Return Presentation Options: The 2020 GIPS Standards allow for the presentation of time-weighted rates of return (TWR) or money-weighted rates of return (MWR, formerly referred to as internal rates of return, IRR) depending on the control of external cash. In particular, the GIPS standards allow for the presentation of MWR if any of the following conditions exist within the investment vehicle: illiquid investments, fixed life, closed end, and/or commitment based.

Alternative investment strategies are seeing record inflows as investors look for higher yields in a low interest rate environment. In seeking a competitive edge, many alternative investment managers will benefit from the enhancements the 2020 GIPS standards provide, leading to increased rates of compliance in the sector.

Due to the recent increase in demand for GIPS compliance, primarily driven by institutional allocators, the GIPS standards have become an agenda item in many investment committee meetings. With the proper education, planning, and resources, GIPS compliance can be achieved in a reasonable timeframe. For firms that do not have in-house GIPS standards expertise, we recommend hiring an outside consultant/verifier that is knowledgeable, especially with applicability to credit managers. A gap analysis project will help firms understand any potential issues to be overcome to claim GIPS compliance. The gap analysis will also assist in the development of a roadmap by which the firm can allocate time and resources, should the firm decide that GIPS compliance is a worthwhile endeavor.

Perspectives in Operational Due Diligence

By: Wendy Beer, Managing Director, Head of Business Consulting, Wells Fargo Prime Services

Following is a compilation of several interviews conducted with allocators, regarding ODD.

What can you tell us about trends in outsourcing, and institutional investors' evolving attitudes toward it?

We have seen an increase in quality of outsourcing middle office, COO, compliance, etc. As a general matter, the first question we ask is, "Is there a value proposition to outsourcing?" In addition, although a role may be outsourced, the critical issue is whether the manager maintains control over the responsibilities. The past few years have seen a maturation and sophistication in the availability of outsourcing options. Key elements of a successful outsourcing program include:

- Outsourcing firm is a known entity by allocators
- The hedge fund manager maintains oversight responsibility for whatever function the outsourced firm is performing
- A named individual at the hedge fund maintains ultimate responsibility for the outsourced function
- Typically the CCO title should not be outsourced, nor the ultimate responsibility for a function. The person wearing the CCO hat can be solely dedicated to the role or wear dual-hats. The real issue is experience and actual responsibilities versus titles.

What trends are you seeing around fees and expenses?

In addition to the obvious downward pressure on fees, managers are facing greater scrutiny of fund expenses. In particular, investors want transparency on the firm's policies and procedures around segregation of management expenses versus fund expenses.

Questions frequently arise around whether outsourced roles should be paid for by the management company or the fund. This might depend on disclosures in the offering docs, but this can be tricky if there is precedent for a function being paid for by the management company. For example, if a function such as reconciliation had been performed internally (and therefore was paid by the management company), but is then outsourced to a third party, that needs to be disclosed. Managers should consider soft dollar guidance when considering such changes, but ultimately should consult with their attorneys.

What are the core control areas investors are focused on in ODD?

Cash controls are a key area of scrutiny due to the operational and business risk. The past few years, there has been an increase in cyber-crimes involving social engineering to misdirect payment of wires. Multi-factor authentication, including call-backs, documented policies and training/testing to make sure the policies are being followed, requiring checks with administrators and/or PBs prior to wires being sent, are all critical components of effective cash controls.

Ensuring that there is a clear segregation of duties between the investment team and operations/control functions, is a particular area of focus during ODD. This encompasses not only reviewing policies and procedures, but interviewing employees at various different levels of seniority in the front, middle, and back office. We pursue a trust but verify approach.

We hear conflicting accounts of whether or not investors are becoming more flexible around board of directors requirements. For example, if they still need two outside directors, or if it matters if the two Directors are from the same firm?

Typically, the board will have three directors with two independent and one internal. We don't have an issue if the two directors are from the same firm. Generally, if the two directors are from the same firm, we are more focused on the different value the directors might be bringing – i.e., one has a legal background and other audit/tax.

What are some of the top themes you encounter in conflicts of interest?

Affiliated entities and related party transactions are the biggest ones we see. In this area we look for adequate disclosure, and also check that any benefits are going back and forth, not one way.

Anytime a fund has illiquid assets we spend a fair amount of time reviewing valuation policies and valuation committee policies and procedures, who sits on it, are there records, etc.

- Valuation becomes more of an issue with level 2 and 3 assets
- Usually, we won't question valuation methodology but will check to insure that the practices match the policies and procedures and line up with disclosures in the fund documents.
- Valuations are a core part of the ODD process for a fund having illiquid assets due to the many ways it can impact fees, redemptions, etc.

It is worth noting that what we are looking for is making sure that policies and procedures are objective - not looking to second guess managers' judgment.

We recognize that there might be a tension between the investor's desire for transparency and the manager's sensitivity to proprietary information. In what context does this dynamic typically manifest itself and what are some of the solutions?

- For example, we might ask to see the firm's compliance policies and procedures but they only let us review on-site. That's fine. Ditto with any SEC and/or other regulatory letters they might have received.
- Areas that might become a bit more sensitive and are harder to find the right balance could involve how the CCO is managing (testing for issues) around quant code.

Have there been any general changes and/or trends impacting documents that you've observed or that can become an issue in ODD?

We prefer to see investor terms in the offering documents rather than in side letters. An MFN and side letters raise the potential for any investors who are not part of the side letter to be harmed.

What types of things arise during ODD that could be deal breakers?

One of the top reasons we might not recommend an investment is if we spot independence issues. Similar to issues around affiliated transactions, if a fund is managed within a family office, there will be serious questions about what controls are in place to ensure that the investment manager doesn't disadvantage limited partners of the commingled fund.

Having service providers that are appropriate for the AUM and strategy of the fund can also be an issue. While they may be more forgiving of certain service provider selections for new launches, institutional allocators prefer that fund managers have administrators with whom that they are familiar.

Tell us what a manager can expect to answer about their cybersecurity program as part of a typical ODD process?

Basically, we want to check that the manager has set up appropriate policies and procedures around the core areas: governance, access controls, network storage, data loss prevention, vendor management, training and incident response.

- We also take our cues from what the SEC has brought enforcement actions based upon: deficient policies, inadequate due diligence on vendors (is the manager sending a DDQ to vendors?), risky behavior around messaging and email, how breaches have been responded to.
- We evaluate processes around defining what is considered a breach, who decides if the definition is met, and if investor notification required?
- Does the manager have multiple layers of security on cloud based applications?
- Is the manager conducting testing to ensure that its policies and procedures are being followed and work as expected?

The Top 5 Pitchbook Mistakes

By: Blayn Barnard Smith, Founder, ImageArb

Let's be honest, few investment managers get excited about working on marketing collateral. Still, the majority of managers use a presentation, investment memo, or "pitchbook" to showcase their strategy and offering to prospects. The form and length vary widely based on audience, strategy complexity, and manager preference.

Some managers believe the written presentation is of little value and place far more emphasis on in-person meetings or calls. However, without a well-crafted pitchbook, you may never have the chance to give additional color in a verbal presentation.

Your pitchbook should communicate your value proposition or tell your "story" in a way that is both accurate and casts you and your strategy in the most attractive light. The information in the pitchbook should enable the investor to begin thinking about where you and your strategy might fit within their portfolio.

Now, where can you go wrong?

Mistake #1 is crafting what we call The Podium Pitchbook, which means it contains content that would be more appropriate for a spoken presentation at a conference. Wide gaps in the narrative or bullets that don't make sense without verbal color often leave the reader feeling confused. Will they pick up the phone and ask you to come down to their office, have a cup of coffee, and engage in a discussion to fill in those gaps? Maybe, but they're just as likely to delete your email and focus on other compelling opportunities. Don't take that chance.

The pitchbook can and should stand alone to thoroughly yet succinctly describe what you do even when the reader does not (yet) have the benefit of speaking with you.

Mistake #2 is failing to get your key takeaways across in the first four or five slides. Always assume your reader won't take the time to flip through all 15 or 20 slides. Get your important points across early.

Too often, managers use several slides to describe market conditions or the market opportunity early in the presentation. In a few cases, this is appropriate, but most managers should create an executive summary that gives a bullet or two on the firm, strategy, objective, and portfolio.

Follow the executive summary with these slides in no particular order: the strengths of the firm and approach, the track record, and, in the case of emerging managers, the portfolio manager's bio.

Don't make the mistake of putting your key takeaways slide at the end of the presentation as a summary, or if you do, make sure you've covered the same information very early in the narrative.

Mistake #3 is making your reader expend too much mental effort to interpret charts and graphs. Draw a conclusion for your reader. The point of the slide can usually be made in a sentence or two. The chart should offer supporting data for your statement.

Mistake #4 is too much information. With rare exception, don't send out a 45-slide presentation. You're not trying to avoid a due diligence process with a single piece of marketing collateral. The pitchbook should be a fairly detailed overview that effectively showcases your strengths and answers most of the questions an investor would have during an initial evaluation.

Mistake #5 is falling victim to the myth of the secret sauce or, in other words, giving too little information. Transparency engenders respect, and if someone can precisely replicate what you're doing after reading through 15 slides, is it really worth your fee structure? Describe what you do. Don't be too cautious about providing a reasonable level of detail.

In crafting your presentation, perfection is the enemy of excellence. We've seen managers become paralyzed trying to incorporate every well-meaning friend's advice into their presentation. Your pitch will never be perfect. Use it, make note of questions you get repeatedly, and consider tweaking to address.

The goal of your pitchbook is to capture the reader's interest so you can progress to the next stage with your prospect.

Decisions, Decisions: New Partnership Audit Considerations

By: Douglas McKay, Partner, Gabe Fox, Tax Manager and Brian Essman, Tax Manager, Marcum LLP

As if there weren't enough decisions to be made when filing a partnership tax return (Form 1065 U.S. Return of Partnership Income), partnerships now need to make another critical decision when filing their return. For tax years beginning after December 31, 2017, partnerships must annually select a Partnership Representative (PR) in place of the former Tax Matters Partner (TMP) adhering to the new centralized partnership audit procedures under the Bipartisan Budget Act of 2015 (BBA), P.L. 114-74. Unlike the TMP, a PR can make decisions that will ultimately bind the partners of the partnership to any decision made as a result of an audit. Individual partners no longer have the right to appeal any adjustments agreed to by the PR. It is possible that the new procedure may lead to more Internal Revenue Service (IRS) audits of partnerships, as it will be easier for the IRS to collect from all partners any proposed adjustments agreed upon by a single representative of the partnership.

New Partnership Audit Rules under the BBA

Under the new partnership audit regime, unless an election is made to opt out of the centralized partnership audit regime under IRC Sec. 6221(b), a partnership will now owe an entity-level income tax (referred to as an "imputed underpayment"), should an adjustment be determined as the result of an audit. If the partnership elects to opt-out (assuming it meets the requirements of IRC Sec. 6221(b)(1) as discussed below), the partnership under audit will follow the rules under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), P.L. 97-248, and the partners will be subject to any adjustments on a partner-by-partner basis. As it is more difficult to pursue individual partners, eligible partnerships may elect out of the new BBA rules by checking "No" for question 25 on page 3 of Form 1065. However, many partnerships will be unable to elect out of the new BBA rules due to eligibility limitations. Partnerships eligible for opting out must have no more than 100 partners, and all partners must be individuals, C corporations, foreign entities that would be taxed as a C corporations were they domestic, S corporations, or estates of a deceased partner.

Partnership Representative

The Partnership Representative replaces the Tax Matters Partner previously designated by the partnership for tax years beginning prior to January 1, 2018 (unless a valid election is in effect for any partnership tax years beginning after November 2, 2015, and before January 1, 2018). The PR and TMP are representatives of the partnership who act as the liaison between the partnership and the Internal Revenue Service if the partnership is selected for an audit. Under the old rules, the TMP had to be a General Partner of the partnership and did not have the authority to bind the partners within the partnership. Section 6223 of the Internal Revenue Code has been amended due to the BBA and now sets the rules for the PR. The PR does not need to be a partner in the partnership or have any affiliation to the partnership. For example, the PR could be designated to be a partner from an accounting firm or a law firm.

Under Section 6223(a), the PR can be anyone with a substantial presence in the United States and will have the sole authority to act on the behalf of the partnership. Substantial presence is defined in the regulations as a person who meets the following three criteria. First, the person must be able to meet within the United States at a reasonable time and place. Second, the person must have a United States address and telephone number and be reachable during normal business hours. Third, the person must have a Taxpayer Identification Number (TIN). However, the PR's TIN does not need to be listed on Form 1065 (although there is a space to enter the TIN). While the PR can be an entity, a designated individual (DI) must be selected and satisfy the substantial presence requirement as well. If the PR is not selected by the partnership, the IRS may designate one. Should the PR need to be changed, a new PR can be designated on Form 8979, "Partnership Representative Revocation, Designation, and Resignation Form," following the procedures set out in the regulations. However, the partnership is not to notify the IRS of the change in PR until the partnership has been notified of an audit or files an administrative adjustment request (AAR) as part of an amended partnership tax return. A partnership may have a different PR for each tax year.

Section 6223(b) states that the PR has the authority to bind the partnership as well as all partners within the partnership. Both the partnership and all partners are bound by any decisions made by the PR in all matters involving any audit, protest to the Appeals Office, legal representation in court to dispute a tax adjustment, and whether or not the partnership elects to opt out of the centralized partnership audit regime. Therefore, partnerships and their income tax advisors should discuss the impact of these new rules, based upon their circumstances, to ensure a suitable PR has been appointed prior to filing future Forms 1065.

As these rules have already been in effect since the 2018 tax year, partnership agreements should be updated to include a section related to the Partnership Representative. As the PR has an enormous amount of authority and responsibility, no choice should be made without consulting the partnership's tax advisor and counsel (internal or external). If an external PR is chosen, it is imperative to make sure that they understand the intentions of the partnership and have well-written contract that spells out the requirements and/or restrictions related to any decisions the PR may make.

Responsible Investment: Key moments and trends from 2019

By: Joshua Card, CEO, Kukua

Despite turbulent markets in 2019, including the US China trade conflicts, responsible investment enjoyed a story of steady growth. More investors than ever are taking environmental, social and governance (ESG) factors into consideration, and in more sophisticated ways. Especially on the issue of climate change. It is no coincidence therefore that 2019 was a year that saw an upsurge in regulatory tailwinds on ESG and, less encouragingly, growing challenges around an abundance of data and the threat of greenwash.

Going wider and deeper

Global assets with an ESG mandate have grown six-fold in the last 15 years to an estimated $30 trillion in 2018, and is set to reach $60 trillion by 2022[1].

From sustainability rankings to scenario analysis, the scope and sophistication of products to help factor ESG issues into investment processes also rose sharply in 2019. This is reflective of a move away from a traditional approach to responsible investment, that relies on exclusions, and towards integrated ESG strategies.

More and more investors also recognise the role of active ownership as a key component of responsible investment, and indeed their fiduciary duty. Investors are actively using proxy-voting and engagement to mitigate financial risks and benefit society. For example, last year Shell commitment to set rolling targets to halve its net carbon footprint by 2050.

Going greener

If there was a responsible investment word of the year in 2019, it was 'climate'. From the ever-growing green bond market to Greta Thunberg's '*How dare you*' speech in New York, climate change became a dominating topic in the sector.

The Paris Agreement[2] of 2015 has given the regulatory direction needed to drive the transition to an economy that keeps global warming to 2ºC or below. And markets have responded. Climate-related shareholder proposals garnered widespread media attention this year, and over 700 companies including Coca Cola, Wal-Mart and MasterCard have committed to tough 'science-based'[3] targets to reduce emissions. In the auto sector for example, many carmakers are announcing a shift towards electric vehicles and other alternative-drive technologies. Over 55% of all new car sales could be fully electrified by 2030, according to PWC[4].

The regulation tailwind and challenges emerge

Historically, regulators have paid rather limited attention to sustainability in the financial sector, but 2019 saw an upswing of activity among legislators, especially in Europe.

In June, the EU Commission's Technical Expert Group[5] on sustainable finance published several recommendations to help set uniform rules on how the integration of ESG risks and opportunities should be understood and implemented. For example, the EU's 'taxonomy', Green Bond Standard and Climate Benchmarks have all been advanced to help create a common definition for how 'green' a financial product is.

Currently, funds and banks are able to sell and label sustainable finance products without an independent arbiter checking the underlying credentials. This has opened the door to so-called 'greenwashing'. For example, several of the world's biggest money managers have been criticized in the Guardian[6] newspaper for offering 'climate-friendly' and 'sustainable' investment funds that have substantial holdings in fossil fuel companies.

In addition to this, the UN-backed Principles for Responsible investors announced it would introduce mandatory questions on climate change for its signatories, and the UK Financial Reporting Council[7] consulted on new rules to make investors explain how they have exercised stewardship across asset classes.

The issue of greenwash was not the only challenge facing the responsible investment sector in 2019. There remains a low correlation and inconsistency between ESG data providers assessing the companies for sustainability with too many differing methodologies, weightings and data collection methods. To overcome this hurdle, investors are increasingly combining multiple sources of ESG data in order to see the bigger picture and arrive at an informed decision.

The space is also moving from data proliferation to signal proliferation, with investors recognising that the value of ESG data as a relevant factor depends as much on knowing why they own something as on knowing what they own.

Last year was a seismic one for the responsible investment space. It is a sector that has matured to the point where it can greatly accelerate market transformation, and while it has significant challenges ahead, we can expect 2020 to be a year when even more investors do well by doing good.

1 Source of data from the Financial Times, https://www.ft.com/content/8d65431c-de0c-11e9-b112-9624ec9edc59.

2 The Paris Agreement, signed in 2016, is an agreement within the United Nations Framework Convention on Climate Change, dealing with greenhouse-gas-emissions mitigation, adaptation, and finance. Further information on this can be viewed at, https://unfccc.int/process-and-meetings/the-paris-agreement/the-paris-agreement

3 https://sciencebasedtargets.org/step-by-step-guide/

4 https://eu-smartcities.eu/sites/default/files/2018-03/pwc-five-trends-transforming-the-automotive-industry.compressed.pdf

5 On 18 June 2019, the European Commission's EU Technical Expert Group on Sustainable Finance (TEG) launched reports on an EU Taxonomy, a voluntary EU Green Bond Standard and voluntary low-carbon benchmarks. Further information can be viewed at, https://www.unepfi.org/news/industries/investment/teg-reports/

6 https://www.theguardian.com/environment/2019/oct/12/top-three-asset-managers-fossil-fuel-investments

7 Further information on the Financial Reporting Council's revised UK Stewardship Code can be found here, https://www.frc.org.uk/investors/uk-stewardship-code

SEC Enforcement Trends 2019

By: Joshua Newville, Partner, and Brian Hooven, Associate, Proskauer Rose LLP

On November 6, 2019, the Enforcement Division announced its enforcement results for FY 2019, accompanied by a report from the Co-Directors of its Division of Enforcement and there are a few key takeaways. While the total number of actions increased slightly from 2018, the percentage of cases involving investment advisers or investment companies increased more dramatically, growing from 22% in 2018 to 36% in 2019, with a significant portion of the increase attributable to the SEC's Share Class Selection Disclosure Initiative. Investment advisor cases accounted for 191 standalone actions in the past year. Insider trading cases decreased slightly from 10% of the actions filed in 2018 (51 actions) to 6% of the 2019 actions (30 actions). Total disgorgement and penalties were also up, reaching $4.35 billion notwithstanding the impact of Kokesh v. SEC, a Supreme Court decision holding that Commission claims for disgorgement are subject to a five-year statute of limitations. The increase in actions, though small, was notable in light of this year's month-long government shutdown and the SEC hiring freeze, which extended through the first several months of FY 2019. The freeze, which may have been the single biggest factor impacting the current Enforcement program, was lifted on April 1, 2019. The 862 total actions and the 526 stand-alone actions brought by the SEC represent the second highest totals ever.

Yearly data from 2014 through 2019 is summarized in the table below:

Fiscal Year	2014	2015	2016	2017	2018	2019
Independent/Standalone Actions	413	507	548	446	490	526
Follow-on Administrative Proceedings[1]	232	168	195	196	210	210
Delinquent Filings	110	132	125	112	121	126
Total Actions	755	807	868	754	821	862

These results also indicate that individual accountability continues to be a priority for the agency's enforcement staff. With 69% of the Commission's standalone actions (excluding Share Class Initiative actions, which, as part of the Initiative, did not include charges against individuals) including charges against individuals, Co-Directors of the Enforcement Division asserted that the Division "remained focused on individual accountability by pursuing charges, where appropriate, against executives at all levels of the corporate hierarchy." Further, the SEC also continues to highlight its work protecting retail or "Main Street" investors. Based on our interactions with senior SEC staff, this focus on protecting Main Street extends to funds that manage pension and retirement fund investments. In particular, several areas have remained important for the SEC.

Valuation. The SEC has and will continue to focus on valuation as a key initiative. For instance, the SEC brought charges against a fund manager, alleging that it overvalued assets in order to collect significantly inflated fees, and the SEC recently settled an administrative proceeding against a portfolio manager for mispricing private fund investments, which resulted in a large personal bonus to that portfolio manager.

In a more novel twist on its traditional focus, in June of last year, the SEC settled an action against a MBS-focused fund manager, based on allegations that the manager had undervalued certain mortgage-backed securities. The SEC alleged that the fund had been one of the most consistently performing hedge funds in the country, and that the undervaluation of these assets may have allowed it to artificially smooth its returns. The order alleged that the valuation policies and procedures weren't reasonably designed because they lacked procedures detailing how to use available market inputs, and that the adviser didn't take reasonable steps to implement the policies that were in place. Consequently, the manager agreed to violations of the compliance provisions of the Advisers Act. Notably, there was no disgorgement assessed.

Trading Violations. Keeping with its announced focus on trading issues, the SEC Enforcement staff has brought several actions regarding trading violations, especially with respect to proprietary or personal accounts also managed by the adviser. For instance, in August the SEC settled charges against a wealth management firm and against a retail investment adviser based on cherry-picking allegations. The SEC has also continued to focus on more technical violations, recently settling charges against a hedge fund manager based on allegations that it misidentified certain short sales of securities as long sales, which caused the manager's books and records to be inaccurate.

Undisclosed fees. Enforcement staff have been highly focused on undisclosed fees charged to clients. In a series of cases over the past year, primarily against wealth managers, they have charged firms with fraud and other violations based on fees that were not adequately disclosed to clients. For instance, undisclosed fee sharing agreements, undisclosed commission charges, and undisclosed incubator fees have all led to enforcement actions.

Custody Rule. There has also been a renewed focus on the Custody Rule in the past year. In September, the SEC charged a hedge fund advisory firm and its principal with violations of the Custody Rule (among other violations). In that case, the manager was unable to obtain unqualified opinions from the audit firm it engaged, and was thus unable to deliver GAAP-compliant audited financial statements to its investors, thus violating the Custody Rule. Compounding the error, the manager incorrectly stated in its Forms ADV that it had distributed audited financial statements prepared in accordance with GAAP, leading to willful violations of Section 207 of the Advisers Act.

Cryptocurrency and ICOs. This past year, the SEC heightened its focus on cryptocurrencies and related issues. Consistent with that focus, the SEC brought a number of cases involving unregistered initial coin offerings, for example: Company Settles Unregistered ICO Charges After Self-Reporting to SEC; Two Celebrities Charged With

1 Follow-on Administrative Proceedings consist of SEC Proceedings initiated following conviction or injunction in District Court.

Unlawfully Touting Coin Offerings. The SEC also brought a pair of settlement orders with respect to registration requirements for a fund and broker dealer operating in the crypto and digital assets space -- the agency's first ever enforcement actions applying the investment company and broker-dealer registration provisions of the securities laws to businesses involved in digital securities.

Furthermore, in June 2019 the SEC released its Interpretive Guidance regarding the fiduciary duties of investment advisers, including the duty of care (which "requires an investment adviser to provide investment advice in the best interest of its client") and the duty of loyalty (under which "an investment adviser must eliminate or make full and fair disclosure of all conflicts of interest which might incline an investment adviser . . . to render advice which is not disinterested such that a client can provide informed consent"). In light of this focus, managers should expect to see a continued focus by Enforcement on actions involving breaches of fiduciary duties and conflicts of interest.

The bottom line for fund managers – expect more of the same from the SEC. The Enforcement Division will almost certainly continue to face some of the same headwinds next year. But as it did this past year, the SEC is likely to overcome those challenges in large part. While the SEC is unlikely to bring the same number of actions as it did three or four years ago, it will almost certainly continue to bring a significant number of actions against private fund managers. In addition, fund advisers should also expect to see more actions involving fees and expenses, valuations, principal and agency cross-trades and insider trading.

SEC's Enforcement of the Compliance Rule

By Donald Babbitt, Partner, Optima Partners LLC

Investment Advisers Act of 1940 ("Advisers Act") Rule 206(4)-7, referred to by the Securities and Exchange Commission ("SEC") as the "Compliance Rule," in relevant part to this article, requires SEC-registered investment advisers ("Advisers") to adopt and implement written policies and procedures that are "reasonably designed to prevent violation, by you and your supervised persons, of the Act and the rules that the Commission has adopted under the Act." This Compliance Rule provision appears to indicate that, in order for an Adviser to violate the Compliance Rule, an Adviser's failure to adopt policies and procedures must result in a violation of the Advisers Act and/or its rules. The SEC, in Advisers Act Release 2204 (Dec. 17, 2003), "Compliance Programs of Investment Companies and Investment Advisers," stated that, "Failure of an adviser or fund to have implemented adequate compliance policies and procedures constitutes a violation of SEC rules independent of any other securities law violation." Therefore, an Adviser can violate the Compliance Rule regardless of whether its failure to adopt and implement policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules results in a violation of any other provision of the Advisers Act. This article provides a review of how the SEC has enforced the Compliance Rule over time.

2011 Compliance Program Initiative

In 2011, the Asset Management Unit of the SEC's Enforcement Division ("Enforcement") implemented the "Compliance Program Initiative" to proactively prevent investor harm by working closely with examiners to ensure that Advisers had viable compliance programs in place. As a result of the Initiative, three firms were charged with compliance failures. All of the Advisers charged failed to adopt and implement written compliance policies and procedures. "The failure to adopt and maintain adequate compliance policies and procedures is a significant violation of the federal securities laws," said Robert Kaplan, then-Co-Chief of the Asset Management Unit. In two of the cases, SEC examiners previously warned the Advisers about their compliance deficiencies.

In 2013, continuing with the Compliance Program Initiative, the SEC sanctioned three more investment advisory firms for repeatedly ignoring problems with their compliance programs. This time, all three had failed to correct ongoing compliance violations at the firm despite prior warnings from SEC examiners.

Recent SEC Enforcement of the Compliance Rule

The SEC has not implemented a program similar to the Compliance Program Initiative that focused specifically on violations of the Compliance Rule regardless of whether the was another violation of the Advisers Act. However, the SEC continues to bring actions against Advisers for violations solely of the Compliance Rule. An example of a recent settlement for a violation of the Compliance Rule in which no other provisions of the Advisers Act were also alleged involved violations by an Adviser for failing to adopt and implement reasonably designed compliance policies and procedures relating to valuation of fund assets. The Adviser's policies failed to address sufficiently how to conform the firm's valuations with US GAAP and its procedures were not reasonably designed for its business practices, given its use of valuation models and pricing vendors, and the potential conflict of interest arising from traders' ability to determine the fair value assessment of a portion of the positions they manage. The Adviser also failed to implement its existing policy and the SEC believed that this may have resulted in certain client assets being undervalued by failing to maximize relevant observable inputs, such as trade prices. The SEC found that the Adviser's CIO was a cause of the firm's failure to implement the valuation policy that required maximizing observable inputs.

Conclusion

The Compliance Rule states that Advisers must adopt policies and procedures "reasonably designed to prevent violation, by you and your supervised persons, of the Act and the rules that the Commission has adopted under the Act." The SEC pronounced that enforcement of the Compliance Rule does not require a violation of any other provision of the Advisers Act and, from 2011-2013, implemented a Compliance Review Program focused specifically on Advisers' violations of the Compliance Rule. Subsequently, the SEC has continued to bring Enforcement actions against Advisers for violations of the Compliance Rule without alleging a violation of any other provision of the Advisers Act.

1 In the Matter of Deer Park Road Management Company, LP, and Scott E. Burg, IA Release No. 5245, June 4, 2019.

2 Outside the purview of this article, and not brought as a cause of action by the SEC in this settlement, the SEC may also charge an Adviser's employees with a violations of Advisers Act Section 203(e)(6) which authorizes the SEC to bring an action against any person who has failed "reasonably to supervise, with a view to preventing violations...another person who commits such a violation, if such other person is subject to his supervision."

Insider Trading Year-End Review

By Carmen J. Lawrence, Partner, Michelle R. Jacob, Senior Associate, and Rafaela Calcena, Associate, King & Spalding LLP

The SEC and DOJ continue to be active in insider trading enforcement. Cases this year highlight key themes including an increasingly data driven SEC docket and a significant number of cases involving professional gatekeepers, including accountants, legal counsel, and auditors. Agency coordination continues to aid enforcement and several high-profile cases have been brought by the SEC and DOJ in parallel.

Securities and Exchange Commission

The SEC brought fewer insider trading cases this year as compared to last year, having brought 30 actions in FY 2019 compared to 51 in FY 2018.[1] These consisted of 22 civil actions and 8 standalone administrative proceedings. The SEC also tried two cases, resulting in one win and one loss.

Data driven docket. A significant number of insider trading cases have originated from the SEC's Market Abuse Unit's Analysis and Detection Center, which uses data analysis tools to spot unusual trading activity. Steven Peikin, Co-Director of SEC's Division of Enforcement, touted the SEC's new and advanced abilities to analyze data in public remarks in September, stating that "in the past year, the Commission also brought significant insider trading cases that may not have been possible without our ability to analyze voluminous amounts of data, including trading data and communications metadata."[2]

- In January, the SEC charged a Ukrainian hacker, six individual traders in California, Ukraine, and Russia, and two entities with participating in a scheme to hack into the SEC's EDGAR system and extract material nonpublic information (MNPI) and then trade in advance of 157 earnings releases, generating at least $4.1 million in illegal profits.[3] The U.S. Attorney's Office for the District of New Jersey brought related criminal charges against two defendants in a 16-count indictment alleging securities fraud conspiracy, wire fraud conspiracy, computer fraud conspiracy, wire fraud, and computer fraud.[4] The cases are pending. As highlighted in the Division's Annual Report, the Analysis and Detection Center provided critical support to this investigation: "Market and trading specialists, using proprietary systems, identified suspicious trading in advance of more than 150 announcements. Through statistical analyses, staff determined that the odds the defendants would have randomly chosen to trade in front of these disparate events ranged from less than 7 in 10 million to less than 1 in 1 trillion. Staff also analyzed IP addresses that accessed various communications and other systems to help establish the connections among seemingly unrelated participants in the alleged scheme."[5]
- In October, the SEC charged Bryan Cohen, an investment banker, and Georgio Nikas, a trader, in connection with an alleged global insider trading ring that amassed tens of millions of dollars in illicit profit.[6] That same day, in a parallel action, the Southern District of New York charged Cohen and Nikas along with four other members of the ring.[7] As part of the ring's alleged illicit conduct, insiders at multiple investment banks obtained MNPI about publicly traded companies and provided that information, sometimes through middlemen, to securities traders who paid for that information and traded on it. Members of this ring allegedly took steps to evade detection by law enforcement, including by using unregistered "burner" cellphones and encrypted applications to communicate. The cases are pending.[8]

Gatekeepers. A disproportionate number of cases—at least eight—involved trading and tipping by internal auditors, accountants, and external or internal counsel.

- In February, the SEC charged a former senior attorney at Apple, who while serving as Apple's global head of corporate law and corporate secretary with duties including overseeing the company's insider trading compliance efforts, allegedly traded Apple securities ahead of three quarterly earnings announcements after receiving confidential draft earnings materials netting approximately $382,000 in combined profits and avoided losses.[9] The U.S. Attorney's Office for the District of New Jersey brought criminal charges in a parallel action.[10] The cases are pending.
- In July, the SEC filed a complaint against Martha Bustos, former accountant and CPA at Illumina Inc., and her close friend Donald Blakstad, who allegedly engaged in a scheme to trade in advance of Illumina's release of confidential revenue information.[11] In exchange for extravagant gifts, Bustos allegedly tipped Blakstad in advance of four quarterly Illumina financial performance announcements. Blakstad then purchased Illumina securities using accounts held by others to conceal his involvement, gaining approximately $4 million personally and tipping at least four others who made $2.2 million. This case is pending along with a parallel criminal action brought by the U.S. Attorney's Office for the Southern District of New York.[12]

Jury trials. The SEC tried two insider trading cases to verdict this year, resulting in one win and one loss.

- In March, after a two-week trial, a Vermont jury found Chad McGinnis not liable on all counts. The suit was initially filed in 2013 alleging that McGinnis, as an IT employee, used his access to shared folders on company servers to review pending press releases and earnings announcements and then traded in advance of at least 10 quarterly earnings announcements gaining $2 million dollars. He also allegedly tipped a longtime friend, Sergey Pugach, who settled with the SEC, without admitting or denying the allegations, in February for $1,769,103 in disgorgement and penalties. At trial, the SEC established a circumstantial case that McGinnis had *access* to the information, traded timely, made large trades including at times borrowing money to pay for them and made large profits which outperformed the stock market index; McGinnis's defense was that there was no evidence he actually possessed MNPI, but instead traded based on substantial research and analysis.[13]
- In August, after an eight-day trial, a Georgia jury found Raymond J. Pirrello Jr., a former registered representative at a brokerage firm, liable for securities violations in connection with what the SEC described as a six-figure scheme in which Pirrello bought MNPI from a former KPMG partner and passed it along to a friend, who then profitably traded on it. The suit was initially filed in 2016 against Pirrello, his friend Lawrence

J. Penna, and Thomas W. Avent Jr., the former KPMG partner. Avent and Penna settled the charges with the SEC, without admitting or denying the allegations. Pirrello was barred from the industry and ordered to pay $21,500 in disgorgement and a $107,000 penalty.[14]

Department of Justice

The DOJ has been active in criminal prosecutions of insider trading cases this past year, including, in addition to the cases noted above, several successful trials and pleas in high-profile cases.

Jury trials.

- In April, following a seven-day jury trial, Sebastian Pinto-Thomaz, a former credit ratings analyst at Standard & Poor's was convicted for participating in two schemes to trade on MNPI in advance of Sherwin-Williams' acquisition of Valspar Corporation which he misappropriated from his employer and tipped to a friend and his hairdresser. Pinto-Thomaz moved to dismiss the indictment based on its failure to allege that the defendants shared a "meaningfully close personal relationship" based on *U.S. v. Newman*,[15] but Judge Rakoff considered the alleged failure irrelevant stating that it is sufficient to express that Pinto-Thomaz had an intention to benefit his friend.[16] Judge Rakoff noted that *Dirks v. SEC* was quite clear on the "wide breadth" of the personal benefit requirement, stating that the inquiry was simply whether the tip involved diverting MNPI for a personal, rather than corporate purpose. Pinto-Thomaz was sentenced in July to 14 months imprisonment and ordered to pay a fine of $15,000 and forfeit $7,500. Co-defendant, Jeremy Millul, pled guilty in March and was sentenced to 5 months imprisonment, fined $20,000 and forfeited $107,000.[17]
- In September, Sean Stewart, a former investment banker, was convicted for the second time following a seven-day jury retrial for allegedly tipping his father, Robert Stewart, with MNPI he misappropriated from his employers concerning five separate corporate acquisitions before they were publicly announced. Previously in 2016, Stewart was convicted and sentenced to three years in prison after a jury trial, but the Second Circuit vacated the conviction and remanded the case holding that the trial judge erred by excluding evidence that contradicted other evidence that Stewart knew his father was trading on the information Stewart provided. Sentencing is scheduled for January 2020.[18]

Continually evolving legal precedent.

- In January, the Second Circuit affirmed – for the second time – the conviction of Rajat Gupta, a former corporate chairman and member of the Boards of Directors of Goldman Sachs and Procter & Gamble who was indicted in 2011 for insider trading. Gupta appealed his conviction in part on the basis that the jury instruction on the "personal benefit" component of an insider trading offense was legally invalid under *Newman*. Gupta argued that the government failed to demonstrate a "quid pro quo" consisting of an "objective gain of pecuniary or similarly valuable nature." The Second Circuit disagreed, finding that personal benefits may be indirect and intangible and need not be pecuniary at all, clarifying that *Salman v. U.S.*[19] rejected the "the Newman formulation" that a tipper must receive something of a "pecuniary or similarly valuable nature" in exchange for a gift to a friend. Noting that there was ample evidence that Gupta and Rajaratnam, with whom Gupta shared MNPI, were frequent business associates and friends, the Second Circuit continued to give broad meaning to the "personal benefit" test from *Dirks*, holding that "where the recipient of the tip is the tipper's 'frequent' 'business' partner, the tipper's anticipation of a quid pro quo is easily inferable."[20] The decision adds to the post-*Newman* cases clarifying that the personal benefit test does not require a tangible or pecuniary benefit.

Guilty pleas.

- In October, Christopher Collins, former member of the U.S. House of Representatives pled guilty to a scheme to commit insider trading and to making false statements to federal law enforcement agents when interviewed about his conduct. Collins served on the Board of Directors and was a significant shareholder of Innate, a pharmaceutical company. Collins tipped his son, who tipped others, about negative drug trial results that allowed his son and the others to avoid over $768,000 in losses. His sentencing is scheduled for January 17, 2020.[21]
- In June, a judge vacated former SAC Capital investment portfolio analyst Richard Lee's plea to insider trading charges that he traded while in possession of MNPI received from company insiders. Because there was no evidence that Lee knew of any personal benefit received by the tipper at the time of the plea, as required by *Newman*, Lee's guilty plea was considered factually insufficient. Prosecutors dropped the charges in November.[22]

1 SEC Division of Enforcement, Annual Report for FY 2019, (Nov. 6, 2019) at 29.

2 SEC Co-Director, Division of Enforcement, Steven Peikin, Keynote Speech at Southeastern Securities Conference 2019 (Sept. 6, 2019).

3 *SEC v. Oleksandr Ieremenko et al.*, 2:19-cv-00505 (D.N.J., Jan. 15, 2019).

4 *United States v. Radchenko et al.*, 2:19-cr-00030 (D.N.J., Jan. 15, 2019).

5 SEC Division of Enforcement, Annual Report for FY 2019, at 13.6

6 *SEC v. Bryan Cohen and George Nikas*, 19-cv-9645 (S.D.N.Y. Oct. 22, 2019).

7 *United States v. Bryan Cohen*, 1:19-cr-00741 (S.D.N.Y. Oct. 22, 2019); *United States v. Nikas et al.*, 1:19-cr-00716 (S.D.N.Y. Oct. 22, 2019).

8 In addition to these two examples, the following cases were assisted by the Analysis and Detection Center: *United States v. Benjamin Taylor and Darina Windsor*, 19-cr-00184 (S.D.N.Y. Oct. 22, 2019); *United States v. Bryan Cohen* (S.D.N.Y. 2019); *United States v. Joseph El-Khouri*, 1:19-cr-00652 (S.D.N.Y. Oct. 22, 2019); *United States v. Georgios Nikas and Telemaque Lavidas*, 1:19-cr-00716 (S.D.N.Y. Oct. 22, 2019).

9 *SEC v. Gene Daniel Levoff*, 2:19-5536 (D.N.J. Feb. 13, 2019).

10 *United States v. Gene Daniel Levoff*, Mag. 19-3507 (D.N.J. Feb. 13, 2019).

11 *SEC v. Blakstad et al*, 1:19-cv-06387 (S.D.N.Y. July 10, 2019).12

12 *United States v. Bustos*, 1:19-cr-00482 (S.D.N.Y. June 28, 2019). *See also SEC v. Walter C. Little and Andrew M. Berke*, 1:17-cv-03536 (S.D.N.Y. Feb. 14 and 22, 2019, final judgments) (law firm partner); *SEC v. Evan R. Kita*, et al., 17-06603 (D. NJ. March 19, 2019, final judgment) (accountant); *SEC v. Paul Bannon Powers*, 6:19-cv-00664 (M.D. Fla. April 9, 2019, filed) (in-house lawyer); *SEC v. Lloyd Schuman and Dane James* (W.D. Tenn. May 9, 2019, settled) (internal auditor); *In re Avent, Jr.*, File No. 3-19322 (A.P. August 7, 2019, settled) (outside accountant), *SEC v. Pirello*, 1:16-cv-02459-WMR (N. D. Ga., Aug. 14, 2019, verdict) (outside accountant).

13 *SEC v. McGinnis*, et al., 5:14-cv-00006 (D. Vt., Feb. 27, 2019).

14 *SEC v. Pirrello* (N. D. Ga., Aug. 14, 2019).

15 773 F.3d 438 (2d Cir. 2014).

16 *See United States v. Pinto-Thomaz* (S.D.N.Y. Dec. 6, 2018). Judge Rakoff relied on *Dirks v. SEC*, 463 U.S. 646 (1983) and *U.S. v. Martoma*, 894 F.3d 64 (2d Cir. 2017).

17 *United States v. Pinto-Thomaz* (S.D.N.Y. July 29, 2019).

18 *United States v. Sean Stewart*, 1:15-cr-287 (S.D.N.Y. Sept. 23, 2019).

19 137 S.Ct. 420 (2016).

20 *Gupta v. United States*, 913 F.3d 81, 86-87 (2d Cir. 2019).

21 *United States v. Christopher Collins et al.*, 1:18-cr-00567 (S.D.N.Y. Oct. 1, 2019).

22 *United States v. Richard Lee*, 1:13-cr-00539 (S.D.N.Y. June 21, 2019).

SEC Warns Investment Companies and Their Service Providers of Common Deficiencies and Weaknesses

By Jonathan D. Blattmachr, Counsel, and Jonathan A. Forman, Counsel, Baker & Hostetler LLP

The SEC's Office of Compliance Inspections and Examinations (OCIE) issued a Risk Alert on November 7, 2019, identifying the most common weaknesses and deficiencies found in its examination of nearly 300 registered investment companies over the last two years. As previous Risk Alerts have foreshadowed the roll out of message cases and enforcement initiatives, funds and their service providers should heed OCIE's warning and address these compliance gaps if they exist.

Fund Compliance Rule. Funds must adopt and implement written policies and procedures to prevent federal securities law violations. Among other things, these policies and procedures must provide proper oversight of the fund's service providers (including its investment adviser, principal underwriter, administrator, and transfer agent) as approved by the fund's board of directors and annually reviewed and updated by its chief compliance officer (CCO). According to the Risk Alert, OCIE observed that many policies and procedures did not account for the fund's business activities or risks. For example, policies and procedures should be tailored to prevent the fund from violating its own investment limitations and guidelines, making misstatements and omissions in marketing materials, failing to oversee its service providers, and mispricing securities. This last observation is particularly important because valuation will continue to be a priority as evidenced by recent enforcement actions and public remarks by the Division of Investment Management that urge the consistent application of valuation procedures that maximize observable inputs and are auditable. Where policies and procedures were tailored, OCIE also observed funds not following them and, as a result, casting doubt on the fund's compliance with various SEC rules, including the affiliated transaction rule. Given all this, these OCIE observations should guide funds because the failure to draft and implement proper policies and procedures is itself a technical violation that likely could result in other federal securities law violations. By complying with this rule, funds, therefore, can kill two birds with one stone.

Disclosures to Investors. Funds must not make any material misstatements or omissions in their registration statements, reports, and other investor documents and SEC filings. According to the Risk Alert, OCIE observed disclosures that were materially inconsistent with funds' actual activities, including service provider compensation and investment strategy changes. Consistency between disclosures and practices is of paramount importance. And, as recent enforcement initiatives have shown, funds should be mindful that the SEC has little patience for "may" disclosures when a registrant knows the occurrence of a fact that should be disclosed.

Section 15(c) Process. The Investment Company Act of 1940 requires a majority of a fund's independent directors to approve investment adviser and principal underwriter contracts. All board members must request and review all information reasonably related to this process, which must be retained thereafter by the fund or its administrator regardless of confidentiality claims by advisers. (In fact, as a signal of potential regulatory creep, at least one administrator was itself subject to an enforcement action for allegedly causing a violation by the fund where it failed to retain such documents as its was contractually required.) This evaluation process must be disclosed to investors in shareholder reports. According to the Risk Alert, OCIE observed funds not complying with each step of the evaluation process, including overlooking information relating to their investment adviser's performance and fees, failing to disclose material factors relating to the board's evaluation, and even failing to retain supporting documentation. Given these observations, funds and their boards should be mindful of their fiduciary duties to ensure that investment advisers are properly engaged and compensated. Among other things, the Risk Alert noted that boards may consider the profitability of the fund to the adviser, economies of scale derived from using the adviser, and advisory fee and performance comparisons as part of this process. Potential conflicts of interest should also be reviewed and disclosed where appropriate.

Fund Code of Ethics. Funds must adopt an ethics code to prevent access persons from engaging in fraud or manipulation vis-à-vis the securities the fund holds or acquires. According to the Risk Alert, OCIE observed that many funds failed to implement an ethics code, including failing to designate a separate individual to review the CCO's personal holdings and activities. In other instances where ethics codes were implemented, OCIE observed funds failing to designate the proper individuals as access persons subject to the fund's oversight. OCIE also observed funds that failed to collect and review the personal securities holdings and transaction reports of access persons. These observations warn funds to appropriately scope out their monitoring and reporting activities. After all, proper oversight of access persons is a baseline measure to fulfill a fund's fiduciary duty to its investors, and one that will continue to be verified by OCIE in future examinations.

Financing Pre-IPO Equity Investments

By Matthew Kerfoot, Partner, Dechert LLP

Investors in pre-IPO companies traditionally have had few liquidity options prior to a public offering. Given that many companies are remaining private for longer periods of time, founders, executives and investors have begun looking for ways to either sell or borrow against their pre-IPO company stock or options. This article provides an overview of the general structure of pre-IPO equity financings and common issues investors face when borrowing against their pre-IPO restricted stock.

Eligible Pre-IPO Companies

First, as a threshold matter, a financing secured by pre-IPO stock can be difficult to obtain when the company has an equity valuation of less than $1 billion. Private companies with a recent valuation of at least $1 billion, commonly called "unicorns", generally provide banks and other lenders with some degree of comfort as to the company's business model and prospects, and usually feature well-known venture capital, hedge fund and other third-party investors in the capital table. In many instances, unicorns will have mutual fund investors that publicly report the valuation of their investments in the company, providing additional transparency to the lender.

General Structure

Credit Agreement or Margin Loan

In many transactions, a bank or other lender will enter into a term loan with the borrower documented with a traditional credit agreement, together with a security agreement that allows the lender to obtain a pledge over the pre-IPO stock. In many cases, these transactions are offered by the same team or desk at the lender that may offer margin loans on listed equities. In that case, the credit agreement will usually be structured and drafted in the form of a customary margin loan agreement, with mark-to-market margining provisions and common margin loan terms.

In some more recent transactions, the loan has been structured as a note issued by the borrower with the terms and conditions set forth in a note purchase agreement. Structuring the loan as a note issuance has been done to create potential liquidity through a secondary note market and to facilitate credit ratings for insurance company investment purposes.

Valuations

Lenders address the valuation of private company stock in a number of ways. If there are recent rounds of capital raising – e.g., in the last six-12 months – this is often the first method the lender will agree to. However, an equity investment may be off-market due to the size of the investment or the relationship of the investor to the company or for a number of other reasons. In these situations, the lender will preserve the ability to override the valuation or seek a valuation from a third-party service.

Mutual funds that invest in pre-IPO companies are required to publish the valuation of their holdings on a quarterly basis. Lenders may also use these valuations or, in many cases, use the lowest mark that has been obtained from any of these valuations.

Less common is the use of a "409A" valuation. Section 409A of the US Internal Revenue Code requires that holders of options recognize as taxable income the difference (if any) between the exercise price and the fair market value of a company's shares at the time the options are granted. As a result, when a company has a 409A valuation performed by an independent valuation agent, there are some who believe that this valuation may be less than fair market value. Accordingly, founders and investors, who rely upon the value of their stock for their borrowing base, are generally reluctant to agree to the use of 409A valuations.

Loan-to Value

Because the value of the pre-IPO stock may be difficult to obtain or verify, and certainly impossible to do so on a continuous, daily basis, loan-to-value ratios for pre-IPO financings are generally limited to 15-25%. Once the LTV is breached, the borrower typically faces a margin call.

In some transactions involving larger, more well-known companies, the lender may agree to a process to allow the investor – usually in this case a founder or executive without other liquidity sources – additional time to sell other shares that are not subject to the pledge to raise additional liquidity to cure the LTV breach.

Covenants, Recourse and Prepayment Events

Lenders usually exercise a significant amount of covenant control over borrowers. This varies in part due to whether the loan is non-recourse, which is the majority of pre-IPO equity financings. In recourse transactions, borrowers will often face restrictions on the ability to incur additional debt – other than residential mortgage debt for individual borrowers – as well as limitations on the ability to sell or assign other assets. Borrowers will also be required to provide financial reports, particularly tax returns for individual borrowers. While non-recourse borrowers may enjoy smaller covenant packages, the cost of the financing will be significantly higher.

Prepayments are a standard feature of these transactions. Borrowers will be required to prepay upon key person events and upon adverse valuation events that may be determined through proxy indices, such as a decline in the NASDAQ or the valuation of an exchange-traded fund that is comprised of public companies in a similar industry as the pre-IPO company.

Restrictions on Transfers and Pledges

Investors in a pre-IPO company typically subscribe for interests in a limited liability company or acquire stock in a private corporation. In either case, the investors become subject to a variety of restrictions on their ability to pledge, assign, sell or transfer their equity interests. As is the case with most private companies, the founders and initial investors exercise control over who may join them as fellow shareholders.

Accordingly, most stockholders agreements or LLC agreements require the consent of the board of the company, and in many cases, certain key investors, before a shareholder can sell its interest. This process may require a certain number of days of notice, plus a requirement to first offer the shares to existing investors in the company. This restriction on sales, however, also will extend to mere pledges of their interests. A common condition to closing is that the company and any relevant investors enter into a waiver of their consent rights and related right-of-first-offer.

Similarly, investors usually have the ability to "tag-along" with a proposed sale of the shares. This co-sale right, particularly when a lender has foreclosed on and looks to sell the shares, may result in a far lower number of shares being sold due to the ability of other investors to sell their position, pro rata, to that potential buyer. Tag-along or co-sale rights are therefore almost always included in the company waiver.

Termination and Renewal

Finally, banks and other lenders subject to regulatory capital constraints will ordinarily limit maturities to 364 days, subject to mutual renewal. In many cases, borrowers will negotiate for an early maturity – without a prepayment penalty – upon the IPO. Given the significantly higher financing rates on pre-IPO equity, shareholders in a successful IPO – post-lock-up – typically have enjoyed a substantial liquidity event and are eager to terminate the financing or refinance the transaction at a far lower rate with publicly traded stock.

Electronic Communications – Best Practices for Designing a Robust Surveillance Program

By Michael Abbriano, Senior Principal Consultant, and Kimberlee Koch, Consultant, ACA Compliance Group

Unfortunately, the convenience that technology offers with respect to business communications often comes at a price. In the event of a regulatory examination or a legal investigation, an adviser's electronic communications ("e-comms") may be subject to intense scrutiny potentially years after they were sent and devoid of much of the original context.

While there is no explicit mandate for an investment adviser to conduct surveillance of electronic communications, advisers do have a duty to supervise "all persons acting on its behalf" with a view toward preventing violations of U.S. securities laws and it is the expectation of the examination staff of the U.S. Securities and Exchange Commission ("SEC") that such supervision will include surveillance of e-comms sent and received by the adviser. Documentation to evidence that such reviews are taking place is commonly requested by SEC staff during examinations.

Apart from simply demonstrating that an adviser is carrying out its duty to supervise, e-comms surveillance is an important tool for advisers ideally to identify and put a stop to flawed communication practices before they become material issues and, in the worst case, to identify and remediate potentially material issues before they are surfaced by SEC examiners.

Following are some best practices for developing an effective program to conduct e-comms surveillance.

Tailor the Surveillance Program to Your Firm

You have a number of decisions to make when it comes to building an e-comms surveillance process. Should testing be conducted internally or outsourced to a third party (e.g., because of a lack of resources or because of concerns related to the review of certain sensitive emails)? How frequently should testing be conducted? What circumstances might prompt an ad hoc or event-driven review outside of the normal review schedule? What methodology(ies) should be used (e.g., random sampling, lexicon-based, or active searching)? The answers to all of these questions should be based on a thorough understanding of your firm and its particular risks.

Approach Each Review with a Fresh Set of Eyes

A strong risk-based e-comm review typically begins with an assessment of what the scope of the review should be. Given the dynamic nature of advisers' business activities, the areas of focus may well change from review to review. For instance, focus areas that may be more relevant at certain times than others could include staffing changes, changes in business activities, new business relationships, marketing activity, political contributions, gifts and entertainment, outside business activities, operational or trade errors, etc.

Additionally, if a lexicon is used to flag emails for review, you should reassess the search terms and phrases periodically to determine whether the list is reasonably comprehensive and whether it is still current and relevant with respect to the risks of the firm. Perhaps certain keywords are resulting in a large volume of low-value hits and should be modified or removed from the lexicon, or perhaps the firm has started working on a new deal involving sensitive information and it makes sense to add relevant keywords (e.g., the company name and/or deal codename) to the lexicon. Additionally, to the extent they are offered by your archival vendor, you should take advantage of more advanced search capabilities such as Boolean logic, proximity searches (i.e., words near other words), and wildcard characters to greatly increase your chances of generating meaningful results.

Use Surveillance to Reinforce Good Habits

One way to reinforce employees' appreciation for the importance of using good judgment in e-comms is to use problematic communications identified through surveillance as teachable moments, whether with the individual employee(s) involved in the communications or for the firm more broadly, as appropriate. Concrete examples help to drive the message home to employees both that their communications are being monitored as well as what types of communications practices are not deemed acceptable by the firm.

Unapproved E-Comms Platforms

Employees may be tempted to use unapproved communications channels if, for example, they are more convenient to access while traveling or if clients or other business contacts express a preference to do so. It is important to be clear in your written policies and procedures and in regular compliance training what platforms are permitted for business purposes and the risks associated with using unapproved platforms.

In order to further discourage the covert use of unapproved messaging platforms, you should foster open communications with employees about their business needs. If there does appear to be a legitimate business need to use a new messaging platform, be thoughtful about whether it might be workable before saying no. For example, contact archival vendors to ask whether they can archive messages from the platform in question in accordance with regulatory requirements. Even if an archival vendor cannot archive such messages directly, it may be the case that they can work with other vendors to convert the messages into a format that can be archived along with the firm's other e-comms.

That said, it will not always be practical to allow every communications platform that employees may want to use. If you know or suspect that these channels are being used for business purposes, it is not enough simply to prohibit a communication channel in your policies and procedures and then turn a blind eye. Your e-comms surveillance should address this risk, and we will discuss additional best practices to monitor for the use of unapproved communications platforms in Part 2 of this series.

Documentation

The importance of documenting e-comms reviews and any subsequent follow-up with employees cannot be overstated. You should maintain records of each review, including date ranges and risk areas covered during the searching, number of e-comms reviewed, issues identified, and actions taken to address the issues. It is a cliché in the compliance field that if something is not documented, then it did not happen, and after all of the hard work you put into designing and executing on your e-comms surveillance program, you deserve to get credit!

What Managers Should Think About When Taking Retirement Money

By Arthur H. Kohn, Partner, Cleary Gottlieb Steen & Hamilton LLP

The fiduciary and prohibited transaction rules (the "Fiduciary Rules") of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), and corresponding provisions of the U.S. Internal Revenue Code (the "Code") may apply to managers of hedge funds in which ERISA plan or IRA account money (collectively, "Plans") is invested, under the so-called "plan asset" rules (the "Plan Asset Rules"). This note highlights a few issues that are important for understanding how those rules apply in practice to hedge fund managers. It assumes basic familiarity with the purpose and nature of the Fiduciary Rules and the Plan Asset Rules.

1. "Class of Equity Interest" and the Plan Asset Rules. The Plan Asset Rules determine whether a manager of a hedge fund in which Plans have invested is subject to the Fiduciary Rules. The principal test is whether 25% or more of the value of any class of equity interest in a fund is held by Plans (the "25% Test"). There is no authoritative guidance that clearly answers many of the questions that arise concerning what constitutes a "class" for these purposes. Very generally, on the one hand there are approaches that look to the materiality of economic differences between separate interests and, on the other hand, there are approaches that look to form. In the economic approaches, questions often arise as to whether differences that arise from side letters, rather than from the terms of the fund documents, should count. Other issues concern the treatment of side pocket investments and exclusions, and different fee and liquidity terms. Managers need to make an assessment about the level of comfort that they have in a particular approach, noting that a more aggressive approach may permit the fund to take in more investment assets.

2. Feeder Funds and the Plan Asset Rules. It is not unusual in a master/feeder structure for a feeder fund to include Plan assets, while the master fund commonly may not. Since all of the investment activity will typically happen at the master fund level, that result substantially limits the applicability of the Fiduciary Rules. However, managers should be aware that any discretion exercised at the feeder fund may implicate the Fiduciary Rules.

3. Plan Asset Hedge Funds. Managers typically try to avoid having a fund include Plan assets, and that is prudent. However, there are many Plan asset funds operating in compliance with the Fiduciary Rules. The ability to do so depends, in large part, on the ability to meet the requirements of various exemptions issued by the U.S. Department of Labor. The most important of these is the so-called QPAM ("qualified professional asset manager") exemption. QPAM and the other exemptions cover a broad range of transactions in a mostly practical way. However, managing a Plan asset hedge fund does require a certain amount of investment in ERISA compliance. It also may subject the manager to scrutiny under the strict fiduciary standards of ERISA, which gives rise to incremental, although hard-to-quantify, legal risk. Finally, Plan asset hedge funds must consider various rules not described in detail in this note, including requirements regarding the fund's liquidity provisions, performance fee structure and reporting of fees.

4. Investment by Principals and Employees of the Manager. Investments by Principals and employees of the manager in a hedge fund raise two issues. First, investments by those persons are excluded from the denominator of the 25% Test, except that investments by IRA, 401(k) or other Plan accounts of such persons are not excluded. Second, investments by those persons implicate the Fiduciary Rules in sometimes technical ways. Violations of the Fiduciary Rules in connection with investments by IRAs can disqualify the IRA, giving rise to large tax liabilities. Accordingly, while such investments are common, they give rise to significant risks, and it is often prudent to consider prohibitions.

5. Indemnification. ERISA states that any provision in an agreement that purports to relieve a fiduciary from liability for breaches of the Fiduciary is void as against public policy. While managers are permitted to be indemnified by certain persons other than the Plans themselves, and are permitted to insure themselves against liability for breaches of the Fiduciary Rules, indemnities from Plan assets are likely not to be enforceable.

6. Indicia of Ownership and Bonding. Two unrelated provisions of ERISA are bunched together in this note because of their technical nature. First, generally, ERISA provides that the "indicia of ownership" of Plan assets are required to be maintained in the U.S. This requirement affects custody arrangements for Plan asset hedge funds. The phrase "indicia of ownership" is a term of art under ERISA, with very little clarity. Managers should ensure that their custodians are familiar with best practices in compliance. Second, managers who manage Plan asset funds generally will be required to obtain special ERISA "Section 412" bonds, which protect Plans against certain losses.

CCPA on Your Mind? Investor Privacy Issues that Hedge Fund Firms Should Prepare For

By Ryan P. Blaney, Partner, Proskauer Rose LLP

The California Consumer Privacy Act of 2018 (CCPA) will take effect on January 1, 2020, and hedge fund firms may be subject to the CCPA even if they are already compliant with the Gramm-Leach-Bliley Act (GLBA).

The CCPA is an expansive new privacy law that gives "consumers" (broadly defined as natural persons who are California residents and can include current and prospective hedge fund investors, employees and job applicants and website visitors) four basic rights in relation to their personal information:

1. the right to know, through a general privacy policy and with more specifics available upon request, what personal information a business has collected about them, from where it was sourced, for what it is being used, whether it is being disclosed or sold, and to whom it is being disclosed or sold;
2. the right to "opt out" of allowing a business to sell their personal information to third parties;
3. the right to have a business delete their personal information, with some exceptions; and
4. the right to receive equal service and pricing from a business, even if they exercise their privacy rights.

Does the CCPA Apply to Hedge Funds?

Only "Covered Businesses" are within the scope of the CCPA, so hedge funds businesses must determine whether the fund fits within that definition. Covered Businesses are those that do business in California with at least $25 million in gross annual revenue that collects personal information from California consumers. In the hedge fund context a consumer includes an employee, job applicant, investor, and a prospective investor. Although "doing business in California" is not defined or addressed in the CCPA, the California tax laws describe "doing business" as meeting any one of the following (1) engaging in any transaction for the purpose of financial gain within California; (2) being organized or commercially domiciled in California; or (3) having California sales, property or payroll exceed certain threshold amounts.

Under the CCPA, the annual $25 million gross revenue threshold includes parent companies and subsidiaries sharing the same branding even if they do not meet the applicable threshold themselves. Many hedge funds firms are erring on the side of over-inclusion of revenue when determining if they meet the $25 million threshold.

Can the Hedge Fund Firm Use the GLBA Exception?

The CCPA does not apply to personal information collected, processed, sold, or disclosed pursuant to the GLBA and implementing regulations. CCPA § 1798.145(e). Investment advisers registered with the U.S. Securities and Exchange Commission are subject to the GLBA. However, the GLBA exception does not categorically exempt investment advisers from the CCPA and most hedge fund firms are collecting personal information that falls outside of the scope of the GLBA exception. For example, employee information, job applicant information, prospective investor information, marketing data and statistics or data scraped or bought outside of the ordinary relationship with the individual may all be covered by the CCPA.

If the CCPA Applies, What Should the Hedge Fund Do?

1. Understand how personal information flows in and out of your business: Create an inventory, or data map, of all personal information from investors, prospective investors, employees and job applicants that you collect, use, disclose, or sell pertaining to California residents, households as well as sources, storage locations, usage and third parties with whom it is shared. Determine whether you are "selling" any personal information to a third party. Selling under the CCPA broadly includes the sharing of personal information for monetary or other valuable consideration.
2. Revise privacy notices and websites: Disclose categories of personal information collected and how data is used, shared and sold. Clearly describe the rights of California residents, including: (a) the right to access personal information; (b) the right to delete personal information; and (c) the right to opt out of the sale of personal information.
3. Prepare to receive, process and respond to requests: Create internal procedures and train applicable personnel.
4. Do not discriminate against clients, investors, employees and other consumers by virtue of their privacy settings: Businesses cannot deny goods or services, charge different prices for goods or services, or provide a different quality of goods or services to those consumers who exercise their privacy rights.
5. Add required provisions to contracts with service providers: To avoid liability under the CCPA you can include the following prohibitions in your agreements with service providers, provided that you do not have actual knowledge, or reason to believe, that the service provider intended to commit the violation in question:
   - The service provider may only retain personal information "for the specific purpose of performing the services specified in the contract" or otherwise permitted under the CCPA;
   - The service provider may only use the personal information "for the specific purpose of performing the services specified in the contract" or otherwise permitted under the CCPA, or;
   - The service provider may only disclose the personal information "for the specific purpose of performing the services specified in the contract" or otherwise permitted by the CCPA.

How is it enforced?

The CCPA can be enforced through actions brought by the California attorney general and, for certain violations, through private law suits brought by consumers. Note that the California attorney general recently issued proposed rules that would expand obligations regarding initial notices at the collection of personal information, privacy policies, rights regarding sales of personal information, and notice of financial incentives for retention or sale of personal information, amongst other changes. The proposed rules are in the comment period and will be enforceable by the attorney general on July 1, 2020.

1 "Personal information" is defined, in part, as information that identifies, relates to, describes, is capable of being associated with, or could reasonably be linked, directly or indirectly, with a particular consumer or household. Note that the definition of "Personal information" does not include publicly available information or consumer information that is deidentified or aggregate consumer information. CCPA § 1798.140(o).

About Wells Fargo Prime Services and Contacts

About Wells Fargo Prime Services

Wells Fargo Prime Services offers comprehensive prime brokerage services and solutions for alternative asset managers. Through our multi-asset class platform, we help managers with their operational and financial goals through our service offerings including:

- Integrated financing solutions
- Technology and operational solutions
- Capital Introduction
- Business consulting services
- Risk management solutions

About the Business Consulting group

Business Consulting services include: business development (from launch to franchise management), best practices, peer analysis and benchmarking, and thought leadership. By leveraging our knowledge of industry service providers we aim to facilitate key introductions and discussions with the goal of achieving the right operational fit for our customers' businesses. We help hedge funds think through strategic business decisions at launch and throughout their life cycle based on a customized approach to meet a client's specific needs.

Wells Fargo Prime Services, Business Consulting

Wendy Beer
Managing Director, Head of Business Consulting
wendy.beer@wellsfargo.com | (212) 214-2078

Krystin Ryan
Vice President
krystin.ryan@wellsfargo.com | (704) 410-1579

Bill Saltus
Director
william.saltus@wellsfargo.com | (212) 214-2031

Jasmaer Sandhu, CAIA
Associate
jasmaer.sandhu@wellsfargo.com | (212) 214-2064

Contributing Authors

Michael Abbriano
Senior Principal Consultant, ACA Compliance Group
mabbriano@acacompliancegroup.com | (917) 635-3840

Donald Babbitt
Partner, Optima Partners LLC
Donald.Babbitt@optima-partners.com | (646) 205-6388

Blayn Barnard Smith
Founder, ImageArb
blayn@imagearb.com | (214) 396.4041

Ryan Blaney
Partner, Proskauer Rose LLP
rblaney@proskauer.com | (202) 416-6815

Jonathan Blattmachr
Counsel, Baker & Hostetler LLP
jblattmachr@bakerlaw.com | (212) 589-4607

Rafaela Calcena
Associate, King & Spalding LLP
rcalcena@kslaw.com | (212) 556-2353

Joshua Card
Chief Executive Officer,Kukua
joshua@wearekukua.com | +44 (0)7710 022 064

Shivani Choudhary
Senior Principal Consultant
ACA Performance Services
schoudhary@acacompliancegroup.com | (312) 270-6370

Brian Essman
Tax Manager, Marcum LLP
Brian.Essman@marcumllp.com | (212) 485-5647

Jonathan Forman
Counsel, Baker & Hostetler LLP
jforman@bakerlaw.com | (212) 847-2855

Gabe Fox
Tax Manager, Marcum LLP
Gabriel.Fox@marcumllp.com | (212) 485-5657

Brian Hooven
Associate, Proskauer Rose LLP
bhooven@proskauer.com | (212) 969-3212

Alice Huang
Partner, Investment Management
Morgan, Lewis & Bockius
alice.huang@morganlewis.com | (852)-3551-8618

Michelle Jacob
Senior Associate, King & Spalding LLP
mjacob@kslaw.com | (212) 556-2237

Matthew Kerfoot
Partner, Dechert LLP
matthew.kerfoot@dechert.com | (212) 641-5694

Kimberlee Koch
Consultant, ACA Compliance Group
kkoch@acacompliancegroup.com | (412) 253-6330 Ext. 3006

Arthur Kohn
Partner, Cleary Gottlieb Steen & Hamilton LLP
akohn@cgsh.com | (212) 225-2920

Carmen Lawrence
Partner, King & Spalding LLP
clawrence@kslaw.com | (212) 556-2193

Douglas McKay
Tax Partner, Marcum LLP
douglas.mckay@marcumllp.com | 212.485.5765

Joshua Newville
Partner, Proskauer Rose LLP
jnewville@proskauer.com | (212) 969-3336

Cindy Pan
Partner, Investment Management
Morgan, Lewis & Bockius
cindy.pan@morganlewis.com | +86-21-8022-8518

Joel Seow
Partner, Investment Management
Morgan Lewis Stamford LLC
joel.seow@morganlewis.com | +65-6389-3005

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