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U.S. Regulatory Update: March 2022

Focus on Private Fund Advisers – EXAMS Risk Alert and Proposed Rules

The SEC has recently put out a wave of regulatory guidance and proposed rulemaking focused on private funds and their advisers. This includes a Risk Alert from the SEC's Division of Examinations focused on private fund advisers, a proposed rule that would require reporting on Form PF within one day of certain actions, a proposed rule that would impose limitations and investor reporting requirements on private fund advisers, and a number of other actions.

Over the years, there has been a steady drumbeat of increased regulation of private fund managers. These actions could signal an acceleration of even greater regulation of private fund managers.

Although the Risk Alert relates to current regulations, the recent rule proposals are just that — proposals. They are not yet final, and the process to reach final, effective rules will take some time. There can be, and likely will be, changes to these proposals.

EXAMS Risk Alert

The SEC's Division of Examinations (the "Division") published a Risk Alert on January 27, 2022 (the "Risk Alert"), highlighting compliance deficiencies observed in staff examinations of private fund advisers. The Division found that private fund advisers (i) failed to act consistently with disclosures; (ii) used misleading disclosures regarding performance and marketing; (iii) failed to conduct adequate due diligence in relation to investments and service providers; and (iv) used potentially misleading "hedge clauses." Many of the deficiencies identified by the Division are not new; however, this Risk Alert shows an increased focus on compliance issues relating to private equity managers.

The Observed Deficiencies

The Division's Risk Alert enumerates a long list of issues identified in examinations of private fund advisers. For example, the Division observed some private fund advisers engaging in conflicted transactions without obtaining the consent of the corresponding limited partner advisory committee ("LPAC"), contrary to fund agreements and disclosures. Other managers failed to follow the disclosed practices for calculating management fees during the post-commitment period or did not comply with the liquidation and extension terms disclosed in their limited partnership agreements ("LPAs"). Others did not act consistently with their disclosed "recycling" practices. The Division noted that these deficiencies caused or could have caused investors to pay more management fees than required under the funds' terms.

Additionally, the Division noted that some private fund advisers implemented investment strategies that materially diverged with those articulated in their disclosures, did not adhere to the processes to replace "key" persons as agreed in their LPAs, or failed to give investors accurate information regarding key portfolio managers no longer employed with the manager.

The Division also identified issues with private fund advisers providing investors misleading performance information or advertising materials, including cherry-picking track-records of a subset of funds, failing to disclose the material impact of leverage on fund performance, using stale performance data when creating track records, or excluding fees and expenses in presentations to investors. The Division also noted that some private fund advisers failed to maintain the necessary records to demonstrate performance calculations in managed accounts or securities recommendations. For example, the Division found deficiencies in disclosures of predecessor performance, and noted that some private fund advisers failed to maintain books and records necessary to back up the cited performance. In addition, some private fund advisers were found to make misleading or incomplete statements about prior awards received or the characteristics of their firm, and some incorrectly claimed that their investments were "supported" or "overseen" by the SEC or U.S. government.

As fiduciaries, private fund advisers must conduct a reasonable investigation into an investment to support a reasonable belief that the advice it provides is in the best interest of the client based on the client's objectives. The Division observed that in some cases private fund advisers were not performing reasonable investigations into investments as described in their policies and procedures or failed to perform the required due diligence on important service providers. Contrary to their disclosures, some private fund advisers did not appear to maintain reasonably designed policies and procedures regarding due diligence of investments as required by Rule 206(4)-7 under the Advisers Act (the "Compliance Rule"). Lastly, some private fund advisers included potentially misleading hedge clauses in documents purporting to waive or limit their fiduciary duty except for certain exceptions, which could violate the antifraud and validity of contracts provisions of the Advisers Act.

Proposed Amendments to Form PF

The SEC's proposed amendments to Form PF ("Form PF proposed amendments") re-imagine the purpose of Form PF and would require reporting to the SEC on timelines that are largely unprecedented for private fund advisers. The proposed amendments to Form PF, if adopted as proposed, would require reporting within one business day of certain material events for large hedge fund advisers and advisers to private equity funds, among other changes. These proposed changes would be significant and are causing concerns among private fund managers.

Current Reporting for Large Hedge Fund Advisers and Advisers to Private Equity Funds

Form PF currently requires certain advisers, including large hedge fund advisers, to file quarterly, and private equity and other advisers to file on an annual basis.

Hedge Funds

The proposed amendments would add a new requirement for large hedge fund advisers to file a current report on Form PF within one business day of certain events with respect to their qualifying hedge funds, including certain extraordinary investment losses, significant margin and counterparty default events, material changes in prime broker relationships, changes in unencumbered cash, operations events, and events associated with withdrawals and redemptions.

Private Equity Funds

The proposal also would require advisers to private equity funds to file current reports within one business day of the occurrence of certain events, including adviser-led secondary transactions, general partner or limited partner clawbacks, removal of a fund's general partner, termination of a fund's investment period, or termination of a fund.

Large Private Equity Adviser Reporting

The proposed amendments would reduce the threshold for reporting as a large private equity adviser from US$2bn to US$1.5bn in private equity fund assets under management. The amendments also would add additional questions relating to private equity funds, the use of leverage and borrowings, including at the portfolio company level, and details about investments in different layers of a portfolio company's capital structure.

Proposed Rule – Private Fund Advisers and Documentation of Annual Compliance Review

On February 9, 2022, the SEC proposed rules (the "Proposed Rule") that would impose quarterly statement requirements on private fund advisers, prohibit certain types of favorable treatment to private fund investors, and prohibit private fund advisers from engaging in certain activities and charging certain fees and expenses. The Proposed Rule would also require all investment advisers to document their annual compliance review. The Proposed Rule's requirements, prohibitions and restrictions on private fund advisers reflect highly prescriptive requirements for a product that has typically been heavily negotiated among sophisticated parties. While some of the requirements do reflect prevailing market terms, others reflect significant changes to current industry practice that could impact the management of private funds and the operations of a private fund adviser's business.

Quarterly Statements

The Proposed Rule would require registered investment advisers ("RIAs") to provide private fund investors with quarterly statements that include detailed information about fees, expenses, and performance of the private fund within 45 days after the end of the quarter.

While some funds already provide periodic performance statements, the requirements of the Proposed Rule would likely require more specific disclosures than is common currently, especially around fees and expenses. For example, the Proposed Rule would require the quarterly statements to include tables that provide: (i) a detailed accounting of all fees paid to the adviser or its related persons by the private fund, (ii) a detailed accounting of all expenses paid by the private fund, (iii) the amount of any offsets or rebates carried forward during the period to reduce future payments, and (iv) a detailed accounting of any compensation, fees and other amounts allocated to the investment adviser or its related persons by a portfolio investment during the reporting period, as well as the fund's percentage ownership in such portfolio investments. The Proposed Rule would require the fund table to show a detailed accounting of fees and expenses, with a separate line item for each category of allocation or payment to an adviser.

The Proposed Rule would also require the quarterly statements to include performance calculated as an annualized net total return for hedge funds or an internal rate of return and multiple of invested capital for private equity funds. For all information provided in the quarterly statements, the Proposed Rule would also require detailed disclosures regarding the calculation methodologies, including the criteria used and assumption made, underlying the information.

The SEC raised questions for commenters in the Proposed Rule regarding whether there should be further prescriptions on the formatting of the proposed quarterly statement, including whether it should use a consistent technological format. The SEC's policy goal is to provide investors with consistent and comparable data so that they can make "apples-to-apples" comparisons among funds. The ultimate impact of this section of the Proposed Rule could be the implementation of an additional required comprehensive quarterly reporting form.

Mandatory Private Fund Audits

The Proposed Rule would require advisers to cause the private funds they advise to undergo an annual audit. This proposal has two main differences from the current requirements under the Custody Rule. First, there is no optionality in the Proposed Rule. Under the current Custody Rule, advisers may choose to cause private funds to undergo a surprise examination rather than an audit; however, under the Proposed Rule, the audit would generally be mandatory.

In addition, the Proposed Rule would require the adviser to enter into an agreement with the auditor pursuant to which the auditor would be required to notify the SEC upon the auditor's termination or issuance of a modified opinion.

Adviser-Led Secondaries

The Proposed Rule would require advisers to obtain a fairness opinion in connection with certain adviser-led secondaries. For purposes of the Proposed Rule, adviser-led secondaries would be defined as transactions initiated by the investment adviser or any of its related persons that offer the private fund's investors the choice to: (i) sell all or a portion of their interests in the private fund; or (ii) convert or exchange all or a portion of their interests in the private fund for interests in another vehicle advised by the adviser or any of its related persons. The Proposed Rule would require the adviser to distribute a written opinion stating that the price being offered to the private fund for any assets in an adviser-led secondary is fair. The fairness opinion would need to be issued by an "independent opinion provider," which is one that (i) provides fairness opinions in the ordinary course of its business and (ii) is not a related person of the adviser. The adviser also would be required to disclose any material business relationships with the independent opinion provider.

Prohibited Activities

The Proposed Rule also prohibits certain sales practices, conflicts of interest, and compensation schemes that the SEC views as contrary to public interest and protection of investors. The prohibited activities under the Proposed Rule are:

Fees for Unperformed Services

The Proposed Rule would prohibit an investment adviser from charging a portfolio investment for monitoring, servicing, consulting, or other fees in respect of any services the investment adviser does not, or does not reasonably expect to, provide to the portfolio investment. These payments sometimes are referred to as "accelerated payments."

Examination and Compliance Fees

The Proposed Rule would prohibit an adviser from charging a private fund for fees or expenses associated with an examination or investigation of the adviser or its related persons by any governmental or regulatory authority, as well as regulatory and compliance fees and expenses of the adviser or its related persons. This prohibition would apply even when such fees and expenses are disclosed to investors in the fund. While market practice is mixed regarding the expenses borne by funds, a strict prohibition on funds bearing certain expenses may require advisers to carefully review the expenses they allocate to the private funds they advise, in particular if they utilize a full pass-through model of expenses. The Proposed Rule would not prohibit funds from bearing expenses associated with regulatory filings and compliance with regulations applicable to the fund, such as Form D filings.

Reducing Adviser Clawbacks for Taxes

The Proposed Rule would prohibit an adviser from reducing adviser clawbacks by actual, potential, or hypothetical taxes applicable to the adviser, its related persons, or their respective owners or interest holders. For purposes of the Proposed Rule, adviser clawback would be defined as any obligation for the adviser, its related persons, or their respective owners or interest holders to restore or otherwise return performance-based compensation to the private fund pursuant to the private fund's governing agreement. Currently, it is a point of negotiation whether clawbacks will be adjusted for taxes borne by the adviser or its related persons; however, the Proposed Rule would mandate that the clawback is assessed on a pre-tax basis. This would represent a considerable change in industry practice on a point that is often negotiated between sponsor and investors, and signals further involvement by the SEC in commercial negotiations. While the SEC noted that the general partners could re-structure the payment of carried interest to mitigate the issue, the SEC did not mention considerations such as taking carry when commercially agreed may be necessary and in the best interest of investors to pay and retain investment professionals/talent.

Limiting or Eliminating Liability for Adviser Misconduct

The Proposed Rule would prohibit an adviser from "seeking reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund." This proposal could constitute a significant change in the terms of indemnification and the standard of care to which private fund advisers are subject. While the SEC has previously indicated its view that advisers cannot exculpate liability for breaches of the federal fiduciary duty, limiting liability for breach of state fiduciary duties is at times permissible under the relevant state law. Further, market practice generally provides for indemnification of the manager, absent willful misfeasance, bad faith, gross negligence, or recklessness. The Proposed Rule's imposition of a negligence standard could mark a significant shift in market practice.

Certain Non-Pro Rata Fee and Expense Allocations

The Proposed Rule would prohibit an adviser from allocating fees and expenses related to a portfolio investment (or potential portfolio investment) on a non-pro rata basis when multiple private funds and other clients advised by the adviser or its related persons have invested (or propose to invest) in the same portfolio investment. The SEC specified that it would view expenses related to consummated and unconsummated investments in the same manner. The SEC recognized that many funds do not allocate broken deal expenses to co-investors and noted that the Proposed Rule generally would prohibit that practice; however, the SEC clarified that "to the extent a potential co-investor has not executed a binding agreement to participate in the transaction through a co-investment vehicle (or another fund) managed by the adviser, the Proposed Rule would not prohibit the adviser from allocating "broken-deal" or other fees and expenses attributable to such potential co-investor to a fund that would have participated in the transaction," provided that those expenses were appropriately authorized and disclosed.

Borrowing

The Proposed Rule would prohibit advisers from "borrowing money, securities, or other fund assets, or receiving a loan or an extension of credit, from a private fund client." Again, these prohibitions would apply even in circumstances where the Fund or its LPAC has provided consent. The Proposed Rule does not make clear how it would address short-term payables owed by the adviser to the fund for, e.g., rebates or re-allocations.

Preferential Treatment

The Proposed Rule would prohibit all investment advisers to private funds, regardless of whether registered, from providing preferential terms to certain investors regarding redemption or information about portfolio holdings or exposures. These prohibitions would only apply to the extent the adviser has a reasonable expectation that the preferential terms would have a material, negative effect on other investors in the same private fund or a substantially similar pool of assets. The Proposed Rule would also prohibit registered and unregistered private fund advisers from providing any other preferential treatment to any investor in the private fund unless the adviser provides written disclosures to prospective and current investors in a private fund regarding all preferential treatment the adviser or its related persons are providing to other investors in the same fund. These disclosures would need to be specific and particular. Such disclosures would need to be provided before a prospective investor's initial investment and annually to current investors if any preferential treatment has been provided since the last notice.

Written Documentation of Annual Compliance Review

The Proposed Rule would also amend the Compliance Rule to require all investment advisers to maintain written documentation of their annual compliance review. While the Compliance Rule does not currently require written documentation of the annual compliance review, many advisers maintain a report of their annual reviews, and such documentation is a common request item during SEC examinations. The Proposed Rule does not enumerate specific elements that advisers must include in the written documentation of their annual review and instead the requirement is

intended to be flexible to allow advisers to utilize the review processes they have found most effective. This Proposed Rule further demonstrates the importance of a strong annual review and the SEC focus in this area.

Other Recent Developments

In addition to the actions described above, the SEC has taken other regulatory actions that could impact private fund managers.

SEC Proposes Amendment to Shorten Settlement Cycle to T+1 by March 2024

As part of its review of market structure, the SEC has proposed rules to shorten the standard settlement cycle for most broker-dealer transactions from two business days after the trade date (“T+2”) to one business day after the trade date (“T+1”). Read more here.

SEC Proposal Would Require Earlier Disclosure of Significant Equity Stakes

The SEC has proposed amendments to Regulation 13D-G that would significantly shorten filing deadlines, expand the application of Regulation 13D-G to certain holders of cash-settled derivative securities and clarify the circumstances under which two or more persons have formed a “group.” Read more here.

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U.S. Regulatory Update: March 2022

SEC: Form CRS Disclosure Best Practices

In December 2021, the Standards of Conduct Implementation Committee of the SEC released a statement regarding best practices for compliance with Form CRS disclosures. The report notes several common areas for improvement identified by the SEC staff.

Form CRS Disclosures

Form CRS is a brief relationship summary designed to better inform current, new, and prospective "retail investors" of registered broker-dealers and investment advisers of services, fees, conflicts of interest and other important information. Each firm required to deliver a Form CRS to retail investors must file the Form CRS with the SEC, as well as make it available to current or potential retail clients and post the Form CRS on its website.

To further the intended aims of Form CRS of transparency and better-informed decision-making, the Standards of Conduct Implementation Committee (the "Committee"), together with the SEC Division of Examinations and the Financial Industry Regulatory Authority ("FINRA") have been assessing the compliance with Form CRS requirements. On December 17, 2021, the Committee shared observations regarding compliance with Form CRS. While the statement notes that many of the Form CRS submissions provided clear descriptions of work services offered and other relevant information, it noted that there were several areas of improvement needed. Below is a summary of best practices released by the Committee, which it encourages firms to implement in their current disclosures.

Form CRS Best Practices

In its statement, the Committee highlighted the following practices in Form CRS disclosures and relationship summaries:

> **Use of Technical Language, Including Disclaimers**: Form CRS disclosures and relationship summaries should be clear, concise, and use plain English. Legal jargon and overly technical language should be avoided.

> **Omission of Required Information**: Required information may only be omitted where the information is not applicable to the business or the specific wording would be inaccurate.

> **Reliance on Proposed, Rather than Final Instructions**: Firms should rely on the final instructions in drafting Form CRS disclosures and relationship summaries. The final instructions provide firms with a detailed guide for completing Form CRS disclosures, and delineate specific requirements for broker-dealers and investment advisers.

> **Lack of Specific References to More Detailed Information**: Specific references to detailed information regarding services, fees and conflicts of interests must be made.

> **Shortcomings in Descriptions of Relationships and Services; Fees, Costs, Conflicts, and Standard of Conduct.** The Committee highlighted the following shortcomings:

> > *Monitoring*: Firms should note whether they monitor investments and to which degree of frequency.

  - > *Investment Authority*: Explanations regarding discretionary authority, and limits on that authority, along with explanations regarding non-discretionary services, should be included in the relationship summary.
  - > *Limited Investment Offerings*: Firms should note if their investment advice is limited to certain types of investments.
  - > *Principal Fees and Costs*: A summary of the fees retail investors can be expected to incur should be included along with a summary of how such fees are assessed.
  - > *Wrap Fee Program Offerings and Fees*: Descriptions of wrap free programs, if offered, should be included.
  - > *Extraneous Disclosures Regarding Standards of Conduct*: Firms must use the appropriate language to describe the standard of conduct to which they are held.
  - > *Firm and Financial Professional Arrangements and Conflicts of Interests*: Firms should disclose how their financial professionals are compensated and should note any potential conflicts of interest that may arise from such compensation policies.

- > **Modification and/or Supplementation of the Disciplinary History Disclosure**: Reference must be made to any legal or disciplinary history.
- > **Issues with Prominently Displaying Relationship Summary on Firm Website**: Current versions of the relationship summary must be posted on the firm's website (if available) in an easily accessible manner.
- > **Issues with Description of Affiliate Relationships**: Affiliated firms offering brokerage and investment advisory services must clearly represent and distinguish the services offered by each firm and must clearly attribute the relevant services to the proper firm.
- > **Poor Design**: Firms should use proper graphic design, including headings, charts, graphs, and other graphics to make the information easier to digest.
- > **Use of Marketing Language**: Relationship summaries should include only factual information and no marketing materials.
- > **Boilerplate**: Vague boilerplate language should be avoided.

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U.S. Regulatory Update: March 2022

Proposed Beneficial Ownership Rule Could Impose New Disclosure Requirements on Investment Managers

The U.S. Department of the Treasury's Financial Crimes Enforcement Network ("FinCEN") has published its proposed rule requiring certain legal entities to disclose information about their beneficial owners (i.e., the people who actually own or control a company) and the persons forming them (the "**Proposed Beneficial Ownership Rule**"). While the Proposed Beneficial Ownership Rule contains exemptions for registered investment advisers and private funds, among others, important nuances could mean that certain fund managers need to file reports for certain entities, such as non-U.S. funds doing business in the U.S., and special purpose vehicles ("SPVs") and other fund subsidiaries.

Background

Reporting beneficial ownership information is seen as a key aspect of combating corruption and money laundering in the United States. In a statement released along with the Proposed Beneficial Ownership Rule, Secretary of the Treasury Janet Yellen commented that the Proposed Beneficial Ownership Rule represents "a major step toward addressing the gaps in our corporate transparency framework that allow corruption to flourish and illicit funds to flow into the United States." Combating corruption has been a consistent focus of the Biden Administration, which highlighted addressing deficiencies in the U.S. anti-money laundering regime by effectively collecting beneficial ownership information in its recent Strategy on Countering Corruption.

The Proposed Beneficial Ownership Rule itself comes at the behest of Congress, which directed Treasury to promulgate such regulations as a part of the Corporate Transparency Act ("CTA") enacted as Section 6403 of the National Defense Authorization Act for Fiscal Year 2021. If promulgated as-is, FinCEN's Proposed Beneficial Ownership Rule would create new requirements for those seeking to incorporate or do business in the United States.

The Proposed Rule

The core of the Proposed Beneficial Ownership Rule requires that certain "reporting companies" (discussed below) seeking to incorporate or do business in the United States file reports disclosing their beneficial ownership and other information with FinCEN.

Filing of Report

The Proposed Beneficial Ownership Rule would require reporting companies to file reports with FinCEN that disclose (i) information about the reporting company, (ii) information about the "beneficial owners" of the reporting company, and (iii) information about the "company applicant" of the reporting company." Under the Proposed Beneficial Ownership

Rule, “beneficial owners” include any individual who (1) exercises substantial control over a reporting company, or (2) owns or controls at least 25 percent of the ownership interests of a reporting company. The Proposed Beneficial Ownership Rule includes definitions for both “substantial control” and “ownership interest” and is meant to capture anyone who is able to make significant decisions on behalf of the entity. For domestic companies, the “company applicant” is the individual who files the document that forms the entity. For foreign reporting companies, the “company applicant” is the individual who files the document that first registers the entity to do business in the United States.

Reporting companies generally will be required to provide the name, birthdate, address, and a unique identifying number from an acceptable identification document (such as a passport or driver’s license) for each individual that is a beneficial owner and company applicant.

The Proposed Beneficial Ownership Rule would give all companies created before the issuance of a final rule one year to submit their reports to FinCEN. After a final rule goes effective, new entities would be required to submit their reports with 14 days after formation of the entity or registration to do business in the United States.

Who Must Report?

The Proposed Beneficial Ownership Rule creates two types of reporting companies — foreign reporting companies and domestic reporting companies. Domestic reporting companies include business entities such as corporations, limited liability companies, limited liability partnerships, and business trusts that are formed under the law of a U.S. State or tribal government. Foreign reporting companies include business entities that are formed under the laws of non-U.S. jurisdiction, and are registered to do business by the filing of a document with a secretary of state or similar office with a U.S. State or tribal government. Many non-U.S. investment funds and other investment vehicles may not be subject to requirements to register to do business in any particular U.S. state and, thus, would not be within the scope of the Proposed Beneficial Ownership Rule.

The Proposed Beneficial Ownership Rule also includes a number of exemptions from the definition of “reporting company.” These exemptions generally track the twenty-three exemptions provided by the CTA and include SEC reporting issuers, banks, insurance companies, broker-dealers, registered investment advisers, venture capital fund advisers, registered investment companies, pooled investment vehicles (e.g., private funds), subsidiaries of certain reporting companies, and so-called “large operating companies” — those who (i) employ over 20 full-time employees and (ii) report over US$5m in business.

Key Observations for Fund Managers

Although the exceptions described above are broadly intended to exclude regulated businesses, the Proposed Beneficial Ownership Rule could impact the fund managers in three crucial areas.

Non-U.S. Pooled Investment Vehicles May Need to Report Control Persons

The Proposed Beneficial Ownership Rule explicitly excludes pooled investment vehicles operated by certain other exempt entities, including banks, registered broker-dealers, registered investment advisers and venture capital fund advisers. However, foreign pooled investment vehicles — non-U.S. entities that would be foreign reporting companies but for the exception for pooled investment vehicles — would be required to file reports with FinCEN that disclose an individual that is a control person of the foreign pooled investment vehicle. Foreign pooled investments vehicles would be exempt from requirements to report persons that own more than 25 percent of the entity.

Subsidiaries of All Pooled Investment Vehicles may be Captured

Subsidiaries of pooled investment vehicles (for example, investment-specific SPVs) are not included in the list of exempt subsidiaries. Further, the Proposed Beneficial Ownership Rule specifically limits private funds that are eligible for the reporting exemption to only those (i) relying on the exclusion from the definition of “investment company” provided by Section 3(c)(1) or 3(c)(7) of the Investment Company Act and (ii) identified in the Form ADV of its

investment adviser. Thus, there may be a number of entities in the structures of private funds that are subject to reporting requirements. The Proposed Beneficial Ownership Rule clarifies that reporting companies with beneficial owners that are exempt entities (e.g., an SPV owned by an exempt private fund) would be required to report the identity of the exempt entity beneficial owner (e.g., the exempt private fund), but would not be required to look-through to the owners of the exempt entity.

Private Fund Advisers: Nowhere to be Found

Conspicuously absent from the exemptions to both the CTA and the Proposed Beneficial Ownership Rule are entities that rely on the private fund adviser exemption from registration as an investment adviser with the SEC and funds managed by such advisers. Thus, as drafted, entities relying on the private fund adviser exemption would need to file reports disclosing the beneficial ownership of their management entities and the funds they advise, including persons that own 25 percent or more of the interests in their funds. Under the CTA and the Proposed Beneficial Ownership Rule, however, venture capital advisers are exempt from reporting requirements. Both private fund advisers and venture capital advisers are "exempt reporting advisers" which are subject to substantially similar disclosure requirements on Form ADV. It is unclear why one class of exempt reporting adviser would be excluded from the Proposed Beneficial Ownership Rule, while the other is subject to the requirements.

Conclusion

While the Proposed Beneficial Ownership Rule is only preliminary, it provides important insight into the requirements and burdens FinCEN intends to impose — and who it intends to impose them on. Companies, and the entities outlined above, should be prepared to compile such information, and think about how beneficial ownership requirements will affect their business in the future, for example, when creating new legal entities. The public comment period for the Proposed Beneficial Ownership Rule ended February 7, 2022. It is not certain when a final rule will be published thereafter.

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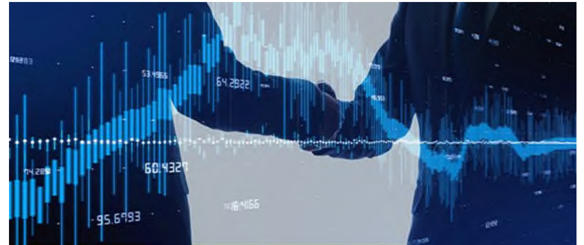
U.S. Regulatory Update: March 2022

Shadow Trading Update – Survival of Motion to Dismiss



On January 14, 2022, the U.S. District Court for the Northern District of California denied a motion to dismiss the SEC case advancing a "shadow trading," insider trading theory, which could expand insider trading liability for market participants in the future.

Background

As discussed in the last quarterly update, the SEC recently charged a former pharmaceutical executive with insider trading based on his purchase of securities in a peer company shortly after learning confidential information that his company would be acquired by a third-party. This practice, often referred to as "shadow trading," was previously considered potentially difficult for the SEC to bring claims pursuant to the insider trading prohibitions.

Motion to Dismiss

In December 2021, the defendant moved to dismiss the SEC's case on several grounds.

First, the defendant argued that the SEC's case failed to adequately allege three important elements of insider trading: (1) that the information at issue was material and non-public; (2) that the defendant breached his fiduciary duty to his company; and (3) that the defendant acted with the requisite scienter. Under the defendant's view of insider trading liability, the SEC must show that a defendant traded in the securities of an issuer on the basis of material non-public information about that specific security or issuer in which the defendant traded. The defendant further contended that the defendant did not breach his duty of trust to his employer, as his employer's policy against insider trading did not "contemplate trading in the securities of an unrelated company." The defendant also claimed that the SEC's allegation that the defendant acted with scienter rests on "nothing more than strained inferences and speculation."

Second, the defendant argued that the SEC's novel application of the misappropriation theory to "shadow trading" improperly expands the scope of insider trading liability, noting that the SEC had never previously brought a case where the material non-public information at issue involved a third party. Allowing the case to move forward, the defendant argued, would make the parameters of insider trading laws "entirely unclear" and would violate the defendant's due process right to fair notice.

Denial of the Motion to Dismiss

The court was unpersuaded by the defendant's arguments.

In response to defendant's non-materiality argument, the court concluded that information "may be material to more than the two companies specifically engaged in the transaction," thus endorsing the SEC's theory of insider trading liability. Further, the court disagreed with the defendant's understanding of the company's insider trading policy and his corresponding fiduciary duty, noting that policy was broadly drafted and covered "the securities of another publicly traded company." The defendant's argument on scienter were similarly dismissed, with the court finding that the SEC's use of circumstantial evidence was appropriate.

The court also disagreed with the defendant's argument that the SEC's theory would improperly expand insider trading liability and violate his due process rights. While acknowledging that this case is the first of its kind, the court reasoned that the SEC's theory of liability "falls within the general framework of insider trading, as well as the expansive language of Section 10(b) and corresponding regulations," and noted that the Supreme Court in *Superintendent of Ins. v. Bankers Life & Cas. Co.* had previously "cautioned against dismissing claims of insider trading predicated on new or unusual schemes." Further, the court concluded that scienter and materiality would be "sufficient guardrails" in preventing insider trading liability from becoming "entirely unclear."

Main Takeaways

No doubt that the facts alleged by the SEC, when taken as true, were important to the court's decision in favor of the SEC. In particular, the facts alleged included a broadly drafted insider trading policy prohibiting the trading at issue, and what the court viewed as persuasive circumstantial evidence. Nevertheless, the court took a broad approach and was open to allowing the SEC's charges to proceed for now, which may lead to more aggressive pursuit of insider trading by the SEC. Indeed, the result here may well indicate future support for further expansion. As a practical matter, market participants should assess their own insider trading policies to see how they compare to the policy at issue here and ensure that compliance training and related procedures take "shadow trading" concerns into consideration.

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U.S. Regulatory Update: March 2022

U.S. ESG – Continued focus on Greenwashing and Ratings

The SEC enforcement staff is reportedly reviewing disclosures made by financial firms in connection with a Texas state law that prohibits the state's government entities from doing business with financial firms that boycott firearms or fossil fuel companies. In addition, statements from the regulators and other recent actions highlight the continued focus on consistency and accuracy of ESG-related data and ratings.

The SEC's Continued Focus on Greenwashing Turns to Texas.

Officials in the Fort Worth, Texas, field office of the SEC have been reported to be currently engaged in an investigation of ESG disclosures by companies doing business with state government entities in the state of Texas. In particular, the SEC seems to be sending inquiry letters to banks that have acted as underwriters in Texas, "scrutinizing potential conflicts between what the underwriters have told investors versus Texas regulators about their policies on doing business with gunmakers and fossil fuel companies."

This activity appears to relate to recent Texas state laws passed in June 2021, which prohibit Texas state governmental entities (e.g., state pensions and municipalities engaging in bond offerings) from doing certain business with firms if they were to boycott firearms or fossil fuel companies. These laws reflected a pushback by Texas against the rising tide of ESG investing. In its continued focus on greenwashing, the SEC appears to be focusing on potential inconsistencies between statements to Texas regulators and statements in public filings by firms that underwrite municipal securities offerings in Texas.

As the SEC's recent probe into such companies in Texas shows, the ESG boom across the world comes with potential risks. First, it is clear that both federal and state entities are gearing up to ensure that companies actually do the work. Last year, the SEC created a new task force within its enforcement division focused on climate and ESG-related issues to identify and address "gaps or misstatements in issuers' disclosure of climate risks under existing rules." The SEC is also expected to publish new rules requiring U.S.-listed companies to provide detailed disclosures on how climate change could affect their business. While we await more specific regulations and guidance, advisors and businesses need to ensure they have a concrete plan to carry out their ESG-related statements and policies. Not acting in accordance with disclosures made to investors could result in greenwashing risks, as evidenced by recent SEC and Department of Justice actions discussed in our previous update.

Consistency and Accuracy of ESG Data

As ESG investing becomes more popular, a plethora of data service providers have emerged that offer ESG research and ratings on companies. These services provide valuable data that can help private fund managers and investors take a more objective approach to ESG analysis. However, there are questions regarding the consistency of this data.

The SEC's Office of Credit Rating in its Annual Staff Report on Nationally Recognized Statistical Rating Organizations ("NSROs"), published January 31, 2022, highlighted some concerns around ESG and ratings agencies, including "the

risks that, in incorporating ESG factors into ratings determinations, NRSROs may not adhere to their methodologies or policies and procedures, consistently apply ESG factors, make adequate disclosure regarding the use of ESG factors applied in rating actions, or maintain effective internal controls involving the use in ratings of ESG-related data from affiliates or unaffiliated third parties. The Staff also identified the potential risk for conflicts of interest if an NRSRO offers ratings and non-ratings ESG products and services."

In addition, following the application of additional criteria, Morningstar, one of the most influential data providers in the world, is reported to have significantly cut the list of funds it recognizes as sustainable –removing more than 1,200 European funds with combined assets of US$1.4trn after further of their legal documents. This significant measure comes as a reaction to the record-high number of assets in funds being promoted as sustainable in Europe at the end of December 2021. Most of the removed funds were Article 8 funds, one of the categories provided by the European Union's Sustainable Finance Disclosure Regulation regime, which means they promote environmental or social characteristics, or a combination of those characteristics. However, Morningstar determined that some funds, which have only added exclusions-related language rather than making material changes to the portfolios or investment strategy, raised potential concerns around greenwashing. This may be a move that shows data standards are increasing, but it also highlights the volatility of ESG ratings.

View our U.S. Regulatory and Compliance Group page here.

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