Regulatory Compliance Watch

COVID-19 COMPENDIUM

A compilation of stories and insights from the **Regulatory Compliance Watch** publication during the early spring coronavirus pandemic

PEI

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Editors letter

During this time may you and your loved ones stay safe and healthy. The covid-19 pandemic has created so much upheaval in only a few months that one investor remarked to PEI Media: "A day feels like a week and a week feels like a month." And unlike previous crises, coronavirus has upended everyone's lives, leaving no one unaffected. The outbreak has induced widespread panic because of many unknowns, not the least of which is when covid-19 will cease to be a global threat. Such extreme uncertainty has pushed the world's economy to the brink of recession, with stock markets in chaos and all industries grappling with how to do business in this strange new environment.

Over the next several pages you'll find insight on some of the most pressing issues for private markets arising from the pandemic. From our ongoing conversations with the sector, RCW has gathered insights and anecdotes on the virus's early impacts that we will share. Expect comprehensive coverage in the months to come as the industry adjusts to operating in a new normal.

Regards,
The PEI staff

WEB EXCLUSIVE: Reg BI: Keep the (good) faith

KKR's four leaders, co-CEOs Henry Kravis, George Roberts and co-presidents Scott Nuttall and Joseph Bae, will forego salary and bonuses for 2020 as part of the firm's pandemic relief efforts.

By Bill Myers

SEC regulators will make allowances for "good faith" efforts to comply with Reg BI, OCIE says in a new risk alert.
SEC regulators will examine for "good faith" efforts to comply with the Commission's new Reg BI rule, OCIE says in a new risk alert.

Chairman Jay Clayton has made clear that, while the agency is willing to be flexible on a host of rules amid the worldwide coronavirus crisis, he's still firm on the June 30 Reg BI/Form CRS deadlines.

OCIE will probably spend the first year after the deadline focusing on whether firms have written policies and procedures "reasonably designed to achieve compliance with Regulation Best Interest," the April 7 risk alert states.

Disclosures, care and conflicts

Examiners will be looking for "whether firms have made a good faith effort" in their P&Ps, the risk alert states. Broker-dealers and dual registrants can expect questions around four main Reg BI issues, OCIE says:

- **Disclosures**, including whether a firm is clearly explaining "material fees and costs," a prospective investment or investment strategy's "material limitations" and in what capacity the B-D is making his or her recommendations.

- **Care obligation**, which requires a B-D "to exercise reasonable diligence, care, and skill when making a recommendation to a retail customer." Reg BI requires broker-dealers to "understand potential risks, rewards, and costs" of a recommendation. "The broker-dealer must then consider these factors in light of the retail customer's investment profile and make a recommendation that is in the retail customer's best interest," the risk alert states.

- **Conflict of interests**, which requires firms "to establish, maintain, and enforce written policies and procedures reasonably designed to address conflicts of interest associated with its recommendations to retail customer."

- **Compliance obligation**, which requires compliance officials to write P&Ps "reasonably designed" to ensure the firm is complying with Reg BI.

Document requests

On disclosure questions, firms can expect to be asked to provide retail investors' fee schedules and disclosures around the schedules, and for documents that show how firms pay its registered brokers, "including (i) compensation associated with recommendations to retail customers, (ii) sources and types of compensation (e.g., direct payments by an investor, payments by a product sponsor), and (iii) related conflicts of interest," the alert states.

When OCIE wants to know about care obligations, staff will likely ask for documents that show how firms develop their retail customer profiles, the processes by which a broker-dealer "believe that the recommendations are in the best interest of the retail customer," how the B-D makes recommendations on "significant investment decisions"—such as "rollovers and account recommendations"—and how a firm makes recommendations in "more complex, risky or expensive products," the alert states. When staff focuses on conflicts, OCIE will likely ask for P&Ps about how a firm discloses instances where a broker has an incentive to place his or her interest above their client's interests, "material limitations" such as limited offerings, proprietary-only offerings or "third-party arrangements," and how well the P&Ps eliminate conflicts such as sales contests, quotas or bonuses, the alert states.

> "the policies and procedures establish a structure for identifying the conflicts that the broker-dealer or its associated person may face," the alert states. "Staff may request documentation identifying all conflicts associated with the broker-dealer's recommendations."

To examine questions about compliance obligations, OCIE will request documents that help them "evaluate any controls, remediation of noncompliance, training, and periodic review and testing included as part of those policies and procedures," the alert states.

Signature rule

Clayton did make clear in an April 2 announcement that he considers Reg BI too important to relax. The regulation could well be the signature rule of Clayton's era at the Commission. The chairman and his staff have also made clear that what they want to see is effort.

"The reality may be that if firms can demonstrate, preferably document, that they made a good faith effort to comply—even if they didn't achieve perfect compliance—OCIE will help them succeed," Troutman, Sanders' lawyer Kurt Wolfe tells Regulatory Compliance Watch.

SEC Chairman Jay Clayton says his regulators will make allowances for "good faith" efforts at Reg BI, but the June 30 deadline won't change.

> "I don't see a ton of deficiency letters or enforcement referrals on the horizon in the near-term. I suspect action from the exam team or enforcement staff will be limited to firms that really missed the mark or didn't take adequate steps to comply."

Underlining Wolfe's point, OCIE's risk alert says that staff "will also evaluate whether firms have made reasonable progress in implementing those policies and procedures as necessary or appropriate, including making such modifications as may be necessary or appropriate, in light of information gained from the implementation process and other facts and circumstances."

SEC providing coronavirus-related regulatory relief

Strings attached if you wish to delay filing Forms ADV and PF

By Hugh Kennedy

Teleworking mandates, travel restrictions, movement controls, social distancing and other coronavirus counter measures are requiring a great deal of flexibility from all. Fortunately, the SEC is also affording flexibility to the financial services industry in the form of regulatory relief & guidance.

On March 13, the Commission announced some regulatory relief for investment advisers and investment funds whose operations are likely being affected by covid-19. The relief covers in-person board meetings (see related story) and certain filing and delivery requirements.
The "targeted relief will provide additional time so affected funds and advisers can continue meeting the expectations of their investors and clients," said SEC Chairman Jay Clayton.

Form ADV/PF filing relief

Key among the welcome relief is tied to the Form ADV and Form PF filing requirements for registered investment advisers and exempt reporting advisers. An extension states that an investment adviser must file the Form ADV or Form PF and brochure "as soon as practicable" but not later than 45 days after the original due date.

The stated conditions are that the IA or ERA is unable to meet a filing deadline or delivery requirement due to the coronavirus. Firms also must "promptly" provide the SEC via e-mail (IARDLive@sec.gov) and disclose on their public website information that it is relying on the relief order, a brief description of the reasons for not being able to timely file, and the estimated date that it will be able to file by. For Form PF the e-mail address is FormPF@sec.gov.

Evaluate obligations

The SEC reminds that advisory clients and the agency have an interest in the timely availability of required information about IAs. The Commission reminds IAs relying on the order to continue to evaluate their obligations, including their fiduciary duty, under the federal securities laws.
The investment company relief order provides for the following:

- A registered management investment company or business development company and any IA of or principal underwriter is exempt until June 15, 2020 from the requirements imposed under the Investment Company Act that votes of the board of directors of either the registered management investment company or BDC be cast in person under certain conditions.
- A registered fund that is required to file Form N-CEN under Investment Company Act rule 30a-1 or Form N-PORT under rule 30b1-9 is temporarily exempt from such form filing requirements until April 30 under certain conditions.
- A registered management investment company is temporarily exempt from the requirements of Investment Company Act rule 30e-1 to transmit annual and semi-annual reports to investors until April 30 under certain conditions.
- Closed-end funds and BDCs are temporarily exempt from the requirement to file with the SEC until June 15 notices of their intention to call or redeem securities at least 30 days in advance if the company files a Form N-23C-2 with the Commission fewer than 30 days prior to, including the same business day as, the company's call or redemption of securities of which it is the issuer where certain conditions are met.

The SEC also noted that it would not recommend an enforcement action if a registered fund does not deliver to investors its current prospectus where the prospectus cannot be timely delivered because of circumstances related to covid-19. The allowance is for "not later than 45 days after required."

The SEC stated that going forward it will consider additional relief from other regulatory requirements. The extension of the time period for relief will also be considered.

SEC issues CAT exemptive and 'no-action' relief

Gabriel de Alba, Catalyst's managing director and partner, sees the disruptive impact of the covid-19 outbreak as potentially lasting throughout 2020 and into 2021.

By Hugh Kennedy

The coronavirus pandemic has information technology professionals across the financial services industry taxed to the max. The SEC has recognized that covid-19 has necessitated broker-dealers and SROs to implement their business continuity plans. Stresses on their IT infrastructure have also been acknowledged by the Commission.

In a bid to allow firms to "maintain focus and reduce operational risk" during these trying times, the SEC has issued a "no-action" letter regarding the SROs' enforcement of their Consolidated Audit Trail compliance rules through May 22 (RCW, 3/18.2020)

The move will afford personnel working on CAT matters who are also important to maintaining critical operations and implementing BCPs to focus their attention on immediate needs.

Testing progress made

The relief was announced March 17 in a statement from SEC Chairman Jay Clayton in an update on the CAT. He noted that FINRA and the national securities exchanges have made progress with CAT testing in advance of B-D reporting. The test environment for B-D reporting was opened last December and Clayton noted that a wide range of B-Ds have been actively testing their ability to report to the CAT.

Clayton assured that despite the "no-action" relief, the SEC remains committed to "establishing a fully operational CAT …. It is important that CAT implementation becomes a reality," he added.

Protecting sensitive information

A key with the oft-delayed project has been ensuring the protection of sensitive information submitted to the CAT. The chief concern: retail investors' personally identifiable information. To that end, on March 17, the SEC took "another significant step towards a more secure CAT," by issuing relief that exempts the SROs from collecting or retaining

Certain retail customer data, including:

- Individual Social Security numbers or individual taxpayer ID numbers;
- Dates of birth; and
- Account numbers.

Instead, broker-dealers would be required to report an account holder's name, address, and birth year. Clayton expressed confidence that the move "represents an important step in significantly reducing the risk of retail investor identity theft associated with the CAT."

Clayton still would like to see the Commission consider additional steps to ensure the security and confidentiality of CAT data. He has asked SEC staff to prepare a recommendation for the Commission on improving the CAT's data security requirements "this year" and has offered up about a half dozen questions he would like to see answered.

Clayton further pledged that the SEC will continue to closely monitor the impact of covid-19 on the roll-out of CAT.

FINRA oversight

A little less than a week before the SEC provided the CAT exemptive relief, FINRA's Board of Governors met remotely due to the pandemic and approved changes to the SRO's systems and operations to comply with its oversight obligations as an SRO in the CAT environment.

FINRA noted that, as broker-dealers begin reporting to the CAT, the changes approved will enable the SRO to integrate this data into its surveillance patterns and other applications and to adapt its examination programs accordingly.

Argument made for Volcker Rule seed extension

By Bill Myers

American regulators should give extra time for banks to "seed" private funds, the IAA says in new Volcker Rule comments.

The Trump Administration's proposed overhaul of the Volcker Rule should go even further by making clear that it may take more than three years to seed a private fund, the Investment Adviser Association says.

Under proposed rules—the second major reform of the Volcker Rule in less than six months—banks would be allowed to sponsor or invest in venture capital funds, credit funds, family wealth management vehicles and so-called "customer facilitation vehicles"—funds created solely at a single customer's request (RCW, Feb. 6, 2020). The association says it's generally happy with the direction of the proposal but wants regulators to give banks time to evaluate their options.

> "Agency staff issued guidance in 2015 that regulated funds should not be treated as banking entities during the period in which the bank-affiliated asset manager is testing the fund's investment strategy, establishing a track record of the fund's performance for marketing purposes, and attempting to distribute the fund's shares, i.e., the seeding period. The staff recognize that the seeding period for a regulated fund may take some time,"

association General Counsel Gail Bernstein says in comments submitted to the SEC and other financial regulators April 1.

Equal application

It would also help if the seeding rules were applied equally to covered funds that plan on becoming regulated funds, Bernstein's letter states. Currently, such funds have to ask the Federal Reserve's Board of Governors for one-year seeding extensions, and they aren't given the benefit of exceeding the three-year seeding limits. But those funds "face the same seeding timeline challenges as regulated funds and we believe that their seeding period should be treated the same," Bernstein says.

Although the Administration's proposed reforms predate the worldwide coronavirus crisis, the pandemic is very much a part of IAA's pitch. In her letter, Bernstein argues that volatile times may mean that banks, or bank affiliates, may have to take more than the 25% ownership stake in a fund currently required by law. This has been an ask by the association for years but Bernstein says that the covid-19 crisis underlines its urgency.

In addition, Catalyst is fielding public-market opportunities from the holders of bonds and loans of listed businesses with liquidity challenges. As the volatility increases and debt becomes downgraded, de Alba said, collateralized-loan-obligation and other passive debt vehicles will be impacted and forced to sell.

$1 billion-plus to invest

Catalyst, which makes control and influence investments in distressed and under-valued situations by acquiring senior secured debt, closed its fifth fund in 2015 at $1.5 billion. Because of the long-running bull market and high valuations, it has been selective about doing deals, de Alba said, preserving its capital.

Catalyst as a result has $1 billion-plus in dry powder to invest in "historical opportunities" in a downturn, de Alba said. Along with rescue financings, these opportunities will include operational turnarounds of leveraged companies, which have been a Catalyst staple since its launch in 2002.

Canada's economy is especially vulnerable in a prolonged slowdown, de Alba said, because of its exposure to volatile commodity prices. Catalyst has a key position in the home market, he said, as regulatory and structural factors impede foreign distressed PE investors from acquiring significant stakes in businesses in major industries.

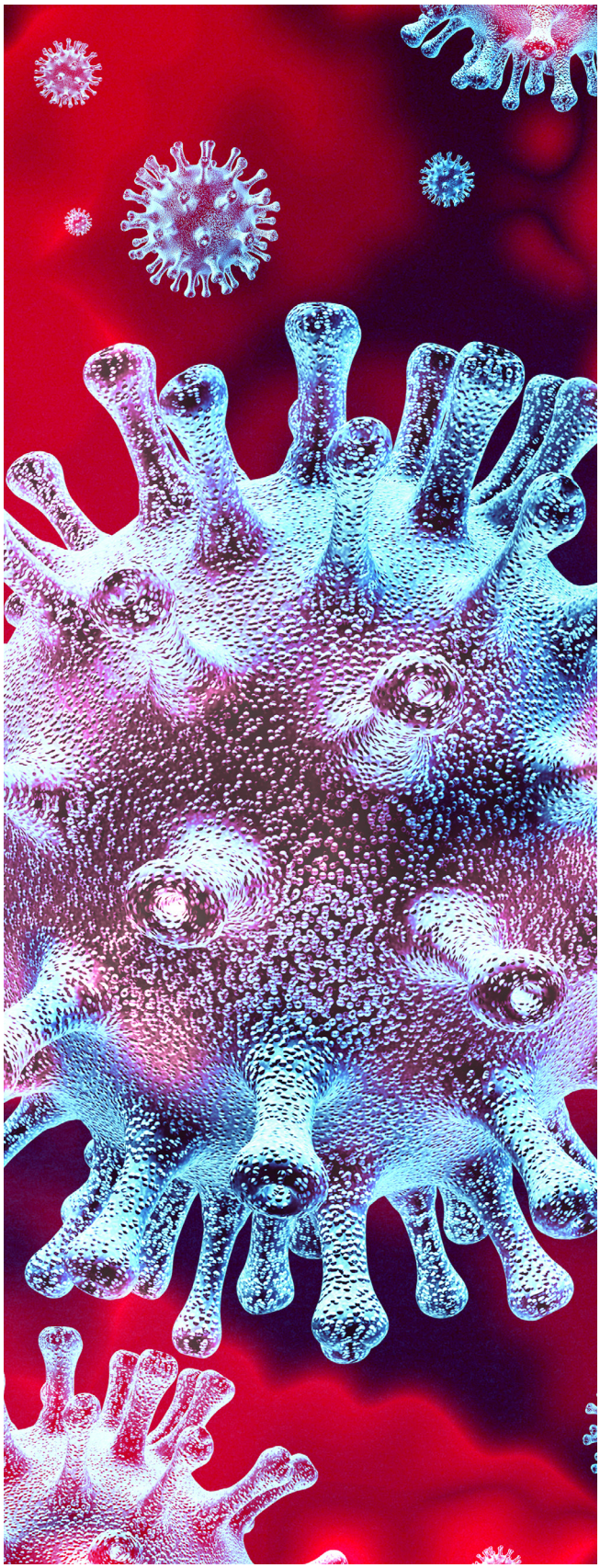
De Alba does not expect to see demand for distressed PE and rescue strategies coming only from sectors immediately impacted by the coronavirus outbreak. Instead, because of the pandemic's far-reaching effects, he expects deal flow to be "across the board."

Catalyst has been active on the deal front in recent months. In January, Gateway Casinos & Entertainment, a gaming and entertainment business owned by Catalyst since 2010, agreed to merge with Leisure Acquisition Corp. The $1.1 billion deal will include an investment by HG Vora Capital Management.

Catalyst also exited is minority investment in Hudson's Bay Co, the owner of Saks Fifth Avenue, with the March close of the retailer's $1.5 billion privatization.

The firm played a central role in prompting a higher bid from the buyout group, led by Hudson's Bay chairman Richard Baker and joined by investors like Rhône Group.

Catalyst was founded by de Alba and managing partner Newton Glassman, a former executive with Cerberus Capital Management. Other senior team members include managing director and COO Rocco DiPucchio and managing director James Riley.



PODCAST: LP defaults, force majeure and over-collateralization amid covid-19

Our senior editorial teams covering PE, private debt, infrastructure, real estate and secondaries discuss the latest in how private markets are responding to the coronavirus pandemic. Plus: ways firms are helping people out in the crisis.

By Adam Le

Our latest coronavirus special podcast looks into LP defaults, how they might play out and what this could mean for GPs and their subscription credit lines. We delve into the rise of digital infrastructure funds and how they're experiencing a boon as covid-19 forces more than half the world's population to work from home.

We also examine the private debt collateralized loan obligation market, the impact of tenants defaulting on rent payments and what that means for private real estate funds, and some of the ways private markets firms are doing good deeds during the crisis.

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