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Industry and Regulatory Updates

Highlights

Industry Trends .... page 1
Addressing trends in the alternative asset industry

- Coronavirus Considerations for Investment Managers
- Coronavirus Response Act Impacting Employee Leave
- Coronavirus-Related Cybersecurity Risks
- The SEC's Focus on ESG
- Practical Guide to Improving Diversity and Inclusion
- Diversity and Inclusion and the Battle for Talent
- How to be Inclusive in Five Minutes

Legal & Regulatory Trends .... page 8
Focusing on topical legal and regulatory concerns

- Temporary Conditional Relief from Certain Filings
- Filing Deadlines, Second Quarter Issues
- Issues Successful Start-Up Managers Face - Part 1
- Insider Trading
- Alt Data and Operational and Compliance Issues
- SEC and Cyber Priorities
- Electronic Communications - Part 2

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Industry Trends

Coronavirus Considerations for Investment Managers

By: Steven B. Nadel, Partner, Seward & Kissel, LLP

As the impact of the Coronavirus continues to grow, set forth below are a number of practical considerations for investment managers:

- Disclosure and Transparency. With clients and investors raising questions about what managers are doing to address possible disruptions in their business from the virus, managers should adopt a consistent approach in terms of communicating to clients and investors. Managers should also consider appointing a primary spokesperson to address any queries that may arise.
- BCP Testing and Implementation. Managers should test all aspects of their business continuity plan as soon as practicable to highlight and, to the extent possible, address any issues before the plan is to be fully implemented. This testing should also encompass the ability to transition to backup personnel, in the event that primary personnel become unavailable or incapacitated. Moreover, the plan should be nimble enough to implement quickly any governmental, CDC or WHO recommendations.
- Working Remotely. To the extent feasible, personnel should have access to backup power and cellular data connectivity, in case their primary electricity supply or Wi-Fi becomes interrupted due to localized overuse.
- Coordination with Service Providers. Since investment managers are often heavily reliant on many third parties such as accountants, lawyers, prime brokers and administrators, management personnel should check with such service providers to confirm their business continuity readiness and work with them to implement any requirements that may be needed to assure continued servicing of clients or, in the event of a disruption, an uninterrupted transition. This is especially important with regard to subscription and redemption processing, trade execution, and payments in general.
- Valuation and Liquidity. As certain assets may become less liquid in various markets, managers should review their governing documents to understand the options they need to consider in the event of redemptions. In addition, firm management should speak with their outside accounting and valuation firms to determine appropriate valuation protocols, particularly if liquid assets suddenly become less liquid.
- Regulatory Filing and Trading Requirements. Managers must continue to remain vigilant in terms of compliance with their regulatory filing and trading obligations, and need to be attentive to new regulatory prohibitions that are being passed in relation to the Coronavirus situation.
- Other Ongoing Obligations. All firm personnel, especially those who will be working off-site and/or using their own personal phones and computers, should be mindful of their ongoing privacy, confidentiality and record keeping obligations.

House Passes Families First Coronavirus Response Act, Impacting Employee Leave; Senate Passage Expected

By: Richard J. Rabin, Partner, Akin Gump Strauss Hauer & Feld, LLP

**as of March 17, 2020*

Key Points,

- On March 16, 2020, the U.S. House of Representatives passed an amended version of the FFCRA.
- The FFCRA includes two different coronavirus-related paid leave requirements for employers with fewer than 500 employees.
- Employers will receive a tax credit intended to offset the costs of additional leave required by the FFCRA.
- It remains unclear whether the U.S. Senate will adopt the House's legislative package or develop a proposal of its own.

With the continued spread of novel Coronavirus (COVID-19) across the country, U.S. employers are facing

the prospect of employees seeking coronavirus-related leave with increasing frequency. To alleviate the financial burdens placed on affected employees, the U.S. House of Representatives recently passed, and then amended, the Families First Coronavirus Response Act (FFCRA) (H.R. 6201). The FFCRA contains two different laws—the Emergency Paid Sick Leave Act and the Emergency Family and Medical Leave Expansion Act—that include additional paid leave requirements for employers with fewer than 500 employees. The Department of Labor has the authority to exempt businesses with fewer than 50 employees from each Act's leave requirements. Employers of health care providers and emergency responders also have the right to exclude such employees from the leave provisions contained in each Act. Both Acts, which are discussed in detail below, expire at the end of 2020.

To offset the costs to employers providing leave, the FFCRA sets up a mechanism for the government to reimburse employers through a tax credit. House Speaker Nancy Pelosi has claimed that the credit will fully pay for the cost of additional leave that is required by the statute.

The Emergency Paid Sick Leave Act

The Emergency Paid Sick Leave Act (EPSLA) provisions of the FFCRA require covered employers to provide paid leave to employees under certain circumstances:

- Full time employees are entitled to 80 hours of paid leave at their regular rate of pay or the minimum wage, whichever is greater, as determined under the Fair Labor Standards Act (FLSA) or state or local law, if they take leave due to a government quarantine or isolation order, to self-quarantine on advice of a health care provider or to obtain a medical diagnosis after experiencing symptoms of COVID-19.
- Part-time employees taking leave for the reasons listed above must be paid at their regular rate of pay or the minimum wage, whichever is greater, for the average number of hours they work over a two-week period. Should a part-time employee have a varying schedule, employers should calculate the average number of hours the employee was scheduled to work per day in the previous six months or the average amount of hours the employee was expected to work per day upon hiring, depending on length of employment.
- If an employee (full time or part-time) takes leave to care for (i) an individual that is subject to a government quarantine or isolation order or has been advised by a health care provider to self-quarantine, or (ii) a child subject to a school or daycare closure, their leave is paid at two-thirds their regular rate of pay or the minimum wage, whichever is greater.

Employers need not provide paid leave at a rate more than $511 per day, or $5,110 in aggregate, for those instances described above where employees are entitled to pay at their regular rate. For those instances where leave is paid at two-thirds employees' regular rate, employers need not spend more than $200 per day, or $2,000 in aggregate. Employers must provide employees the paid leave prescribed under the Act, regardless of length of employment. Employers are prohibited from requiring employees to use other types of leave before using EPSLA leave. Employers must also post notice of the requirements of the Act in a conspicuous place on their premises where notices to employees are customarily posted. The Secretary of Labor will make publicly available a model of such notice.

The Emergency Family and Medical Leave Expansion Act

As part of the FFCRA, the House also passed the Emergency Family and Medical Leave Expansion Act (FMLA Expansion). The FMLA Expansion allows employees of covered employers that have been employed for at least 30 calendar days to take up to 12 weeks of leave under the FMLA to care for a son or daughter under the age of 18 if their school or place of care has been closed, or the child care provider of such son or daughter is unavailable, due to a COVID-19 related emergency.

While the first 10 days of this leave may be unpaid, after 10 days, the employee is entitled to be paid two-thirds their regular rate of pay for the number of hours they would otherwise be normally scheduled to work. For employees with variable schedules, employers must take into account the average number of hours they were scheduled to work in the previous six months or the amount of hours they were expected to work upon hiring, depending on length of employment. At no point will employers be required to provide paid leave to an employee that exceeds $200 per day, or $10,000 in the aggregate.

Small businesses with fewer than 50 employees may be exempted from the civil enforcement provisions of the Act. Employers with 25 or fewer employees may further be exempted from the restoration of employment provisions of the FMLA under certain conditions.

Next Steps

The FFCRA is not yet law. The Senate is expected to consider the FFCRA this week, and passage is expected, most likely without substantial changes. Employers should continue to monitor Congress's activity to obtain up-to-date information on how policy changes, including those related to paid sick leave, may affect them moving forward.

Homeland Security Warns of Coronavirus-Related Cybersecurity Risks — Considerations for Private Fund Managers

By: Brian T. Daly, Partner, Marc E. Elovitz, Co-Managing Partner, Edward H. Sadtler, Partner, and Kelly Koscuiszka, Special Counsel, Schulte Roth & Zabel, LLP

On March 5, 2020, SRZ hosted a webinar on coronavirus preparedness during which we addressed certain cybersecurity and data risks that arise from working in a distributed workforce environment, as well as risks from cyber criminals exploiting the curiosity and fear surrounding the coronavirus outbreak.[1] On March 13, 2020, the U.S. Department of Homeland Security's Cybersecurity and Infrastructure Security Agency ("CISA") issued a warning about these issues and encouraged organizations that move to a remote working environment "to adopt a heightened state of cybersecurity."

CISA *Guidance*. The March 13, 2020 CISA Alert lists a number of cybersecurity risks associated with telework, such as increased reliance on virtual private networks ("VPNs") that may not be updated with the latest security updates and patches or that do not utilize multi-factor authentication ("MFA") for remote access. CISA's Alert also

recommends specific steps businesses can take to mitigate these increased risks:

- Update VPNs, network infrastructure devices and devices being used to remote into work environments with the latest software patches and security configurations;
- Alert employees to an expected increase in phishing attempts;
- Ensure IT security personnel are prepared to ramp up remote access cybersecurity tasks, including log review, attack detection and incident response and recovery and document these tasks in the configuration management policy;
- Implement MFA on all VPN connections to increase security (or if MFA is not implemented, require teleworkers to use stronger passwords);
- Ensure IT security personnel test VPN limitations to prepare for mass usage and, if possible, implement modifications — such as rate limiting — to prioritize users that will require higher bandwidths; and
- Contact CISA to report incidents, phishing, malware and other cybersecurity concerns.

CISA and other government agencies have been warning for several weeks about the risks posed by cyber criminals and other scammers exploiting the pandemic.[2] While cybersecurity risks may be exacerbated in a telework environment, remember that they will continue to be heightened in traditional work settings and are not limited to the United States.

Implications for Private Fund Managers. The CISA Alert is not directed at any particular industry or sector, but it has obvious implications for private fund managers. At this point, most managers have tested their disaster recovery/ business continuity plans and many have already shifted to a partial or complete "work-from-home" footing. However, the CISA Alert serves as a reminder that, in some ways, the cybersecurity risks, and need for vigilance, are just starting.

In particular, managers need to be reminding employees of the dangers posed by phishing emails, which are becoming more sophisticated and difficult to spot. Phishing attempts already reported during this crises include:

- Communications that look like they were sent by the World Health Organization[3] or another health or governmental organization;
- Fake purchase orders for face masks or other supplies;
- False "remote workplace testing" emails that request login or other authentication information; and
- Requests for donations that spoof legitimate relief organizations.

To succeed, a phishing attack only needs to convince one employee to click a link, open an attachment, or provide authentication information, which could compromise a manager's security or unleash malware that could render some or all of a company's systems inaccessible for an extended period of time. These threats pose significant harm and business interruptions under the best of circumstances but can be even more debilitating and difficult to address for offices that have moved partially or fully to remote work and reduced on-site IT monitoring and support.

Because employees are a major point of vulnerability, email alerts, trainings (which can be conducted via webinar or teleconference) and phishing tests (i.e., sending phishing simulation emails) can go a long way in mitigating the risks. Many managers have existing information security training programs and materials that can be leveraged for this purpose.

Additionally, while many managers already have a team and response plan in place for cyber incidents, adjustments should be considered to ensure the business is well-positioned to address cyber incidents in the current environment.

As before, should a cybersecurity incident occur, managers are reminded to consider any required notices to personnel or other affected individuals, as well as governmental authorities. For example, if investor information is accessed or extracted from the system, it could trigger reporting obligations under data breach notifications laws.

[1] Please contact events@srz.com if you would like the materials from that webinar.

[2] For example, CISA issued a March 6, 2020 Alert regarding cyber scams related to the coronavirus; the Federal Trade Commission issued a Feb. 10, 2020 Alert related to fake websites, emails and fundraising efforts related to the coronavirus, and the Securities and Exchange Commission's Office of Investor Education and Advocacy issued a Feb. 4, 2020 investor Alert warning investors about investment frauds involving claims that a company's products or services will be used to help stop the coronavirus outbreak.

[3] The World Health Organization maintains a cybersecurity page with tips to assist organizations in validating communications and a link for reporting scams.

As the SEC Takes on Greenwashing, Here's What Hedge Funds Need to Know

By: Trysha Daskam, Director & Head of ESG Strategy, Silver Regulatory Associates

The SEC—just like seemingly every investor, business, policymaker and regulator in the world—is taking a closer look at ESG.

The recent proliferation of ESG funds and strategies has the potential to, in the words of Larry Fink, create a "fundamental reshaping of finance." Recent studies put the global amount of professional assets under management that apply an ESG lens at about $30 trillion. Approximately $12 trillion of this AUM is in the U.S., with researchers at Deloitte predicting that ESG-mandated assets could nearly triple and make up half of all managed assets by 2025.

Reports of recent ESG-specific fund launches and inflows suggests these numbers will continue to increase. According to Morningstar, more than $20.6 billion flowed into ESG-oriented ETFs and mutual funds in 2019, quadruple the total from the previous year. Also, several prominent hedge fund managers are launching ESG- or impact-focused funds and others publishing their first ESG policies.

As such, it comes as no surprise that the SEC has included ESG among its 2020 exam priorities, specifically referencing their intention to look into disclosure practices. It also recently put out a "Request for Comments on Fund Names" in which they asked if there should be specific requirements that funds must comply with to characterize their investments as "ESG" or "sustainable." While the SEC

has been vague about exactly what they're looking for in terms of ESG compliance and disclosure, initial indications suggest that officials want to understand how different investment advisers are positioning, marketing, and evaluating their ESG products and strategies.

In particular, the SEC is expected to be examining if these products and strategies (and how they are marketed) are in compliance with Rule 206(4)-7 of the Investment Advisers Act of 1940, which requires registered advisers to "adopt and implement written policies and procedures reasonably designed to prevent violation" of the Act.

This rule could have significant ramifications for hedge funds that are new to ESG, whether it's their first time publishing an ESG policy, launching an ESG fund, or adding ESG to their marketing materials. Hedge funds could run afoul of SEC regulations if they materially rely on ESG considerations to make investment decisions but do not articulate this criteria and how they are deciding which ESG factors are material through investor disclosures. The SEC would also expect to see a formal ESG policy or procedure in place to describe these practices. Likewise, hedge funds could also be in violation if they do not have a reasonable program to execute on what their investment policies or marketing documents say they are doing on ESG. This latter violation is better known as "greenwashing".

The Greenwashing Problem

The rise in the amount of ESG-branded products has led to a simultaneous rise in the amount of debate and consternation about "greenwashing," which is loosely defined as the use of green, sustainable or impact labels for an investment strategy that does not effectively take into account ESG considerations. While there can be legitimate disagreements about what is or isn't greenwashing, most market participants would agree that the financial industry is suffering from a proliferation of greenwashing.

According to a February 2020 study published by KPMG, AIMA, CAIA and CREATE-Research, 52% of institutional investors said that there is a significant (41%) or some amount (11%) of greenwashing in the hedge fund industry. This should serve as a warning sign for hedge funds actively marketing their ESG products to institutional investors, especially since the same study found that 55% of investors look at ESG as part of their due diligence prior to making an allocation to a hedge fund manager.

The SEC's ESG sweep exam, among other points of interest, may signal that the regulator suspects there may be a greenwashing problem. But greenwashing can come in many different shapes and sizes, just as ESG can be applied differently depending on the investment strategy and asset class. This lack of an agreement on what constitutes best practices in ESG and lack of regulation of ESG standards, presents both a risk and an opportunity for hedge fund managers—the risk is that managers could be held accountable for potentially misleading investors and suffer redemptions and regulatory scrutiny as a result; the opportunity is that hedge funds can clearly define in their own terms how they think about ESG, and what their practices look like.

The Anti-Greenwashing Checklist

To provide some clarity on what constitutes best practices in the ESG space and to mitigate the risk of SEC scrutiny, here is a five-part anti-greenwashing checklist:

- Develop and publish an ESG policy: Publish an ESG policy or statement that clearly articulates how ESG factors are used to inform and improve investment decision-making. This policy should be shared with investors annually and also made publicly available on the firm's website. If appropriate, the policy should also include case studies that detail how an ESG lens was used to decide whether or not to make an investment in a particular company.
- Hire or appoint an ESG specialist: Designate one or more employees of the firm as the dedicated ESG specialist. This person should ideally have actual ESG or impact investing experience, or a background in sustainability, science, engineering or a similar field. Avoid designating someone who will have difficulty answering basic questions about different ESG market trends, as this could be an immediate red flag for an investor or regulator.
- Conduct ESG training sessions: The ESG specialist(s), either independently, through a committee or with third-party consultants, should host regular training sessions for staff to keep them abreast of changes and development in the ESG space. This also helps prevent miscommunication and confusion across the firm and ensures that employees are able to answer most if not all investor or regulator questions about ESG.
- Participate in industry organizations: In looking for industry standards, there are various organizations to learn from and contribute to. The most ubiquitous is the UN PRI, but there is also the Global Impact Investing Network (GIIN), the Impact Management Program (IMP), the Operating Principles for Impact Management, Ceres, Climate Action 100+ and various regional stewardship codes.
- Report on ESG outcomes: If ESG factors are being used to influence investment decisions, then a hedge fund should be able to report on the outcome of those decisions. Many investment advisers already use the UN's Sustainable Development Goals (SDGs) as their benchmark.. There are plenty of other data frameworks to choose from such as SASB, GRI, CDP and TCFD, just to name a few. Each of these non-profit organizations offers a template for reporting on the different aspects of non-financial performance, so funds should choose the framework that best aligns with their particular investment strategy. Meanwhile, the Big Four accounting firms and the International Business Council are reportedly working on a standardized set of ESG metrics for demonstrating the "long-term sustainability" of companies.

Each of these items is an important part of a hedge fund manager's overall ESG journey. Given that the majority of ESG and impact funds were recently launched and have a limited track record, it's inevitable that best practices will continue to evolve as the market matures. Hedge funds that are serious about protecting their reputation and preserving their business from both investor criticism and regulatory attention should embrace these initial steps to lay a strong foundation for their ESG programs.

The Alternatives: A Practical Guide to How Hedge Fund Firms Large and Small Can Improve Diversity and Inclusion

Q&A with Michelle Noyes, Head of Americas, AIMA

Recently, AIMA published a Practical Guide focusing on improvements to Manager's Diversity & Inclusion efforts. The Guide outlined "steps every hedge fund firm can take to improve its diversity and inclusion (D&I), no matter its size or resources. Fostering greater D&I in the hedge fund industry will require commitment. It will pitch the industry against traditions and social structures that have remained unchanged for decades. Ultimately, however, the hedge fund industry is nothing if not an example of the benefits of breaking with tradition."

Q: Diversity & Inclusion ("D&I") is a broad term we hear often, but can you define what is meant by "Diversity & Inclusion" for the purpose of this paper?

A: Diversity is taken to mean the presence of underrepresented groups from all backgrounds, life experiences, and beliefs. Inclusion is the act of ensuring that all individuals are equally recognized and respected, and are judged only on their contributions to the organization. In the words of one of our members – diversity is inviting someone to the party. Inclusion is asking them to dance.

Q: Why do you think D&I is so important for a hedge fund manager?

A: Clearly, there are strong moral arguments to be made in favor of D&I: an industry founded on the meritocratic ideal should be an industry in which everyone has an equal opportunity, regardless of their background. There are also, however, sound business rationales for fostering D&I. Greater D&I can allow firms to attract a greater amount of talent, and it can improve their decision-making processes. Further, many investors—especially institutional ones—and some regulators increasingly expect managers to show a commitment to D&I.

Q: What are some of the obstacles hedge funds face when it comes to D&I?

A: While a handful of firms employ hundreds of members of staff, even more are too small to even have a dedicated in-house human resources function. Such firms also tend to be too small to hire, and train, junior members of staff. The need to hire experienced individuals has put many hedge fund firms at the end of a long funnel of talent. But there is still plenty they can do, despite the challenges.

Q: What type of importance are investors placing on D&I efforts and does effort count as much as action?

A: Different allocators are approaching it from various angles, but at a high level more questions are being asked. Both about demographics and policies. According to a survey from KPMG published in early 2019, 16% of investors currently require diversity statistics but that number is expected to jump to 37% in 2020. More broadly, 60% of investors have asked about diversity efforts last year, but again that is expected to grow to over 75% this year. AIMA has been working on a DDQ with Albourne that we expect to be published soon, based on an initial template developed by ILPA, to help investment managers prepare for the heightened transparency expectations.

Q: If a firm would like to implement a D&I program, what is the process they should go through?

A: It's critically important to secure buy-in from the top. The next step is to socialize the firm's intentions to act on D&I with the rest of the firm's staff. Firms with middle management should pay particular attention to convincing those managers of the benefits of acting. Internal conversations should allow a firm to formulate a definition of diversity and inclusion that fits their culture. Once a firm decides on the definition, it can begin to gather data on its D&I status. A firm can then adopt a formal D&I policy. Once a firm has acquired internal buy-in, gathered the necessary data, formulated a policy, and implemented the basic policies, it can begin launching initiatives to improve its D&I practices.

Q: What can a small manager do to demonstrate they are trying to be more inclusive?

A: Many small managers hire new employees infrequently so their demographics are unlikely to change in the short term. But that doesn't mean they are without options. They should establish anti-discrimination, anti-harassment, and anti-bullying policies if they don't yet have them. They can engage with their counterparties to drive transparency at banks, law firms and other service providers. Or they can participate in internship programs, work with educational institutions and/or contribute to relevant not-for-profits.

Q: We hear managers say they have a hard time finding diverse candidates. What steps could they take to improve their recruiting?

A: The first thing to emphasize is that it is not about lowering standards. But there are ways funds should think about regarding how they draft the job spec and where they advertise. Studies have suggested that certain language—for instance, language that is seen as overly 'aggressive'—can deter certain groups from even considering a role in the first place. Many firms thus choose to make their job descriptions as 'neutral' as possible. Rather than list requirements, some firms prefer to focus their job descriptions on the outcomes that are expected, and on describing the environment of the firm. The result should be a job description that encourages as many individuals with the right skills to apply as possible. After a job description is agreed upon, it is important to advertise the position as widely as possible to create the broadest talent pool possible for the firm. Many still hire within their own social and professional circles, naturally relying on their colleagues to recommend the best talent. Such an approach, however, constrains a firm's talent pool. Firms relying on third-party recruiters, meanwhile, may wish to encourage them to cast their nets more widely, and to send more applications for consideration.

Q: Hiring someone into a small business (as most hedge funds are) places a great importance on that hire succeeding at their job. How can a manager avoid making the "safe choice" or a bias hire that doesn't support a diverse culture?

A: Hiring managers have strong incentives to choose the 'safest' possible candidate, which often translates into the candidate with the most 'prestigious' background. As such, no changes to recruitment are likely to succeed until a firm takes steps to reframe the hiring process. For many firms,

the hiring process is akin to those investors who only invest in government bonds. Their investments may be 'safe,' but they may ultimately lose out on possible returns. Hiring managers need to know that they will not be penalized for making unconventional choices. Firms may wish to explicitly explain (potentially in their D&I policies) that by only taking the 'safest' approach to hiring they may expose themselves to the greater risk of not hiring the best possible talent. As such, hedge fund firms may be well advised to stress the need for the best—not the safest—talent.

Q: In the report, "de-biasing the process is easier than de-biasing the people" is discussed in terms of interviewing. Can you explain this?

A: Human beings have an affinity bias for those who resemble them, and this can shape perceptions of an interviewee's performance. Unconscious bias training can help mitigate the effects of bias, but members have suggested changing the process may be more effective. Examples of this are moving from unstructured interviews (those open ended conversations seeking 'culture fit') and moved to structured interviews, in which all interviewees are asked the same questions. Firms may also wish to create hiring panels. Such panels, which are not generally large, will review the interview results and vote on the candidate to be hired. By requiring the interviewer or hiring manager to explain their decisions, such panels can further mitigate the role bias plays in the hiring decision. Some firms may even require the hiring manager to justify their decision not to hire the other candidates being considered. If possible a firm may wish to ensure that its hiring panel is itself diverse.

Q: Hiring diverse candidates is a good baseline to develop a diverse firm, but how do managers deal employee retention issues?

A: Once talent has been hired, a firm must determine how to retain that talent, and how to foster inclusion. Retention and inclusion seem to be linked. Firms wishing to increase the retention of their talent, and the inclusivity of their workforces, may wish to determine why their staff stay with the firm, and how they can foster staff wellbeing and inclusion. This can include, but is not limited to, actions such as a regular, anonymous survey of staff; sponsoring affinity groups; ensuring that social events cater to all members of staff; instituting a mentoring or reverse mentoring program; offering members of staff opportunities for personal development; and adopting a policy of parental leave.

Q: Promotion is discussed in the paper. How can managers integrate D&I into their leadership when there may not be much room for formal advancement?

A: Ultimately, in an industry of small businesses that are often led by their founders, there may not be much firms can do about changing the face of their leadership. However, by taking steps to make the promotion process more transparent firms can mitigate the role of biases, and ensure that their staff will be judged only on their merits. Furthermore, some of the promotion actions highlighted in the paper can also be applied to the informal granting of new responsibilities or even, in some cases, the awarding of bonuses.

Q: I have heard there is a shift in thinking, from Diversity & Inclusion to Inclusion & Diversity. The thought being you need to foster an inclusive environment in order to be a diverse firm. For firms struggling to fill seats with diverse candidates, would you recommend leading first with an effort to be more inclusive? i.e. willingness to listen and empower the best ideas and if so how can they make these changes to their structure/culture?

A: Re-ordering D&I to I&D to further emphasize inclusion is an idea that many of our members have mentioned as well. Having a more inclusive firm should lead to an workplace that is more attractive to not just diverse candidates, but all candidates – particularly the younger generations – which is critical for future success.

Diversity and Inclusion and the Battle for Talent: Three key areas a fund should focus on to drive performance

By: Lauren Randall, Business Strategist, Alternative Investment Fund Practice, Marsh & McLennan Agency

From the passing of Title VII of the Civil Rights Act of 1964, to the recent news that Goldman Sachs will no longer do IPOs for companies with all-male boards, diversity and inclusion in the workplace has certainly evolved, yet still has a long way to go, particularly for the financial services industry.

According to AIMA and Ernst & Young's 2019 paper on Diversity and Inclusion, an average hedge fund is roughly 80% male. Senior leadership is 90% male and roughly 95% of founders are male with less than a 10% chance of meeting with a member of an ethnic minority.

The ethical argument for diversity and inclusion is strong, but emerging data now indicates the business case is even stronger. DDI's Global Leadership Report showed organizations that have at least 30% women in leadership roles are 12 times more likely to excel financially. Boston-based consulting firm, Quantopian conducted a study comparing performance of Fortune 1000 women CEOs to the returns of S&P 500 enterprises, finding the 80 women CEOs produced 226% better than the S&P 500. BCG and MassChallenge conducted a study on women founders showing women-led start-ups outperformed their male counterparts, despite receiving less money; for every dollar raised, women generated 78 cents in revenue, compared to 31 cents for men.

The cost of not "buying-in" to D&I is also worth noting, with research into venture capital firms showing the more homogenous a firm's leadership is, the lower their investment performance.

When it comes to diversity and inclusion, the challenges and barriers hedge funds face are somewhat unique. Diverse talent pools are not created overnight and funds face even more headwind in the fight by sourcing most candidates from the financial services/investment banking industries. Evolving business needs have only exacerbated this, with a continued push to hire from quantitative degrees. Not only are funds fighting to take this talent from tech giants like Google and Amazon, these degree programs typically have even lower levels of gender diversity than finance degrees.

While a hedge fund's challenges are unique, the struggle and inherent value of top talent is universal. In 2018, Development Dimensions International conducted a study

with more than 1,000 C-level executives worldwide. When choosing between 28 challenges (ranging from global political uncertainty to climate change to global recession), the C-suite overwhelmingly rated their top challenges to be "Developing 'Next Gen' leaders" and "Failure to attract/ retain top talent."

As a fund evolves to keep up with a rapidly changing business environment, an increasingly competitive and cross-industry battle for talent, the challenge of diversity and inclusion can actually inadvertently become part of the solution. According to a recent study, 47% of Millennials actively look for diversity and inclusion when considering a job.

So how can a hedge fund become more diverse and inclusive? The answer isn't simple nor one-dimensional, but in order to drive progress in talent acquisition and D&I, a fund should focus on three areas:

- Embedding inclusion within a fund's culture
- Top-level leadership "buy-in"
- Innovating the benefits strategy

Embedding inclusion into a fund's culture:

According to Harvard Business Review, numerous studies demonstrate diversity on its own doesn't drive inclusion. DDI's Global Leadership Report showed organizations that have 1.4 times higher sustained profitable growth, do not just hire diverse candidates, but they also embed inclusion within their culture and leadership, valuing multiple perspectives to determine success.

HBR's Center for Talent Innovation's research uncovered four areas that drive inclusion in the workplace: inclusive leaders, authenticity, clear career paths and networking and visibility. Working with a broker or consultant to assess where your firm is currently at in the process can help you build a strong path forward.

Top-level leadership "buy-in":

Inclusive leaders are a key component to creating "inclusion" in the workplace and without backing and executive sponsorship of diversity and inclusion from the top, organic engagement that cultivates innovation and business growth will not happen.

Innovating the Benefits Strategy:

According to AIMA, another talent headwind that funds face is the inaccurate preconceived notions of what the finance industry looks like: 20-hour days, aggression and a rigid culture. As a result, funds are now beginning to adapt their culture and benefits offerings to reflect that of their biggest talent competitor: Silicon Valley.

By putting calculated thought and analysis into areas like perks, pay, flexibility and inclusive benefits, firms can widen their talent pool, improve company culture and gain a competitive advantage in securing top talent. Whether it is lifestyle-spending accounts, fertility treatment, paid paternity leave, or simply more effectively assessing and communicating current benefits offerings, a strategic and evidence-based approach is important. By working with a broker or consultant who uses custom benchmarking from both the tech and hedge fund industries (not financial services as a whole), a firm can better differentiate, innovate and align the benefits package to attract the right candidates that may be getting overlooked today.

Ultimately, there is no one-size fits all approach and it is important to apply an agnostic data-centric approach that objectively weighs the risks of maintaining the status quo against the potential returns of innovation.

Five Minutes for Inclusion: How to Be Inclusive in Five Minutes Per Day and Why That Matters to the Bottom Line

By: Sara Axelbaum, Global Head of Inclusion and Diversity for MiQ

Diversity and Inclusion is a top-of-mind topic in business today. Beyond the simple moral and ethical reasons for being more diverse and more inclusive, there are proven business reasons how it impacts the bottom line. Inclusion is one of the biggest factors in employee engagement. It has been shown that operating income can increase by over 19% and that companies that score in the top quartile for engagement outperform companies in the bottom quartile by 22% in profitability.[1]

Inclusion must be more than simply not being exclusive. It is a business imperative that everyone be purposefully and demonstratively inclusive. A corporate-wide inclusion strategy that weaves throughout the day-to-day operation of a company is the most effective, but every single person can be more inclusive with just a little bit of effort. Here are some ideas:

Examine your partners: Do your partners (clients, investments, supply-chain, service providers, etc) have diverse representation and ownership? Where can you expand to include companies that invest in Diversity and Inclusion?

Amplify someone's voice: Head over to LinkedIn and share articles from and about people who wouldn't ordinarily be in your social circle. For example, if you are a man, share an article talking about female leadership and tag and promote the voice of the author.

Understand your own biases: We all have biases. The Implicit Association Test can help you identify your blindspots so you can take the first steps in overcoming them.

Fine tune your language: Familiarize yourself with inclusive language, because while it may not matter very much to you, it may mean everything to the person to whom you are speaking. For example, pronouns are becoming especially recognizable as a means of inclusion. Adding your own pronouns in your email signature and social media profiles helps normalize it for everyone and is an immediate demonstration that you are an inclusive person.

Use your privilege: If you are in a position to open up a door for someone, ask yourself who you might be able to introduce them to or invite them to a meeting in order to provide access to your network.

One of the best ways to impact inclusion is within meetings. Meetings are an inevitable part of work, but there is no reason they need to be as painful and dry as most are. If someone is delivering information with no discussion necessary, consider giving everyone time back in their day and making it into an email. If you want to engage employees in a meaningful way and if leaders want to demonstrate a culture of inclusivity, meetings are key

to quickly increase feelings of inclusion and employee engagement.

1. Prep and Communicate: People hate to be surprised by the contents of a meeting and it immediately changes the dynamic of power. Spend a few minutes articulating the agenda to all participants in advance and make sure people who you are expecting to speak are prepared to do so (see #2). If you are looking to brainstorm ideas, give participants the questions in advance so they have an opportunity to prepare their thoughts (see #3).
2. Start the Meeting Warmly: In our everyday urgency to get as much as possible packed into a meeting, it's easy to skip the niceties. But a culture of inclusion means investing a bit of time into the lives of our coworkers beyond their work tasks to create a deeper bond. Prepare a question for everyone to answer (and add it into the agenda so people have a moment to compose their answers) and go around the table to hear a bit from everyone. Questions can be anything from "What were your first and last concerts?" to "What food could you not live without?" to "Who has inspired you most so far in your life?"
3. Brainstorm inclusively: Ideas are typically shared most often by the people who are the loudest and most extroverted, leaving out a lot of braintrust. Not everyone communicates in the same way, and meetings with the same group of people typically perpetuate the same people always speaking up. You can inspire participants who are less likely to contribute by evening the playing field and making sure there is no default to the loudest voice. A few things to try:
   - Have everyone put ideas on post-it notes without attribution and then read them outloud.
   - Go around the room and ask everyone to contribute their ideas (without comment). List them on a white board then request follow-up from the group after all ideas are listed.
   - If you have a large group, break off into pairs then come back and have each person articulate their partner's ideas.
4. Prevent interruptions: It has been proven that women are more likely to be interrupted during meetings, which signals that their voices are not as welcome. Help all parties overcome this habit by asking everyone to complete their thought with the phrase "I am finished" and, as the leader, be vocal that no one interupts anyone else. It will be awkward at first, but it also demonstrates, in a very noticeable way, that everyone can thrive at your workplace.

When it comes to Inclusion, a little bit can go a long way.

1 Gallup Meta-Analysis Report

Legal & Regulatory Trends

SEC Provides Temporary Conditional Relief from Certain Form ADV and Form PF Filing Requirements in Response to the Coronavirus

By: David Tang, Counsel, Seward & Kissel, LLP

**as of March 15, 2020*

In light of the disruptions resulting from the coronavirus ("COVID-19"), on March 13, 2020, the SEC issued an order ("Order")[1] granting temporary conditional relief from certain Form ADV and Form PF filing and delivery requirements, as applicable, under the Investment Advisers Act of 1940 ("Advisers Act").[2]

Filing and Delivery Exemptions

Subject to meeting the conditions described below, the SEC granted exemptions from the following filing or delivery requirements, as applicable, for which the original due date is on or after March 13, 2020 but on or before April 30, 2020:[3]

- An SEC-registered investment adviser ("adviser") is exempt from the requirements to (a) file an amendment to Form ADV, including an annual updating amendment, under Rule 204-1 under the Advisers Act; and (b) deliver Form ADV Part 2 (or a summary of material changes) to existing clients under Rule 204-3(b)(2) and (b)(4) of the Advisers Act;
- An exempt reporting adviser ("ERA") is exempt from the requirements to file reports on Form ADV, including an annual updating amendment, under Rule 204-4 under the Advisers Act; and
- An adviser is exempt from the requirements to file Form PF under Section 204(b) of and Rule 204(b)-1 under the Advisers Act.

Conditions for Relief

An adviser or ERA must satisfy the following conditions in order to rely on the relief granted by the Order:

1. The adviser or ERA is unable to meet a filing deadline or delivery requirement due to circumstances related to current or potential effects of COVID-19;
2. The adviser or ERA relying on the Order promptly provides the SEC via email at IARDLive@sec.gov and discloses on its public website (or if it does not have a public website, promptly notifies its clients and/or private fund investors of) the following information:
   - that it is relying on the Order;
   - a brief description of the reasons why it could not file or deliver, as applicable, its Form on a timely basis; and
   - the estimated date by which it expects to file or deliver the Form; and
3. The adviser or ERA files the Form ADV or Form PF, as applicable, and delivers Form ADV Part 2 (or a summary of material changes), as soon as practicable, but not later than 45 days after the original due date for filing or delivery, as applicable.

S&K Observations

In light of current and potential disruptions resulting from COVID-19, advisers and ERAs should assess their ability to meet the filing and delivery requirements, as applicable, of Form ADV and Form PF.[4] Please contact your primary attorney in Seward & Kissel's investment management group or any of the attorneys listed below for assistance with these requirements or the conditions for relying on the relief granted by the Order.

1 See Order Under Section 206A of the Investment Advisers Act of 1940 Granting Exemptions from Specified Provisions of the Investment Advisers Act and Certain Rules Thereunder, Advisers Act Release No. 5463 (March 13, 2020) available at https://www.sec.gov/rules/other/2020/ia-5463.pdf.
2 The SEC also provided an exemption from certain requirements of the Investment Company Act of 1940 for registered investment companies and a statement regarding prospectus delivery obligations of registered funds. See Order Under Section 6(c) and Section 38(a) of the Investment Company Act of 1940 Granting Exemptions from Specified Provisions of the Investment Company Act and Certain Rules Thereunder; Commission Statement Regarding Prospectus Delivery, Investment Company Act of 1940 Release No. 33817 (March 13, 2020) available at https://www.sec.gov/rules/other/2020/ic-33817.pdf.
3 The SEC stated in the Order that "[t]he time period for any or all of the relief may, if necessary, be extended with any additional conditions that are deemed appropriate and the Commission may issue other relief as necessary or appropriate."
4 See also Seward & Kissel's client alert "Coronavirus Considerations for Investment Managers" (March 13, 2020) available at https://www.sewkis.com/publications/coronavirus-considerations-for-investment-managers/.

Filing Deadlines for March, The Second Quarter of 2020, and Action Items

By: Steven Graham, Esq, Partner, Regulatory & Compliance, Constellation Advisers

**as of March 17, 2020*

For planning purposes, we have compiled a list of SEC, NFA and EU AIFMD reporting requirements for investment advisers, CPOs, CTAs, and AIFs and AIFMs. This is not intended to cover all possible filing requirements, but rather to serve as a reminder of several of the most common regulatory filings due in the near future. We hope you find this useful for planning your compliance activities.

In addition to identifying common filing deadlines, Constellation has also provided several action items below to help clients prepare for the upcoming filing season and identify potential additional regulatory obligations that may be applicable as a result of advisory activities during 2019. Because regulatory assets under management (RAUM) could impact several filing requirements (Form PF, transition registration, agency to whom the adviser reports, availability of exemptions, etc.), each adviser should verify its RAUM. For planning purposes, Constellation strongly advises that you determine your RAUM as soon as possible. Here is a brief refresher:

Calculating RAUM. In determining RAUM, include the securities portfolios for which you provide continuous and regular supervisory or management services. Click HERE to see the SEC's instructions for calculating RAUM in response to Form ADV, Item 5.F.

- An account is a **securities portfolio** if at least 50% of the total value of the account consists of securities. For purposes of this 50% test, treat cash and cash equivalents as securities and include: (a) your family or proprietary accounts; (b) accounts for which you receive no compensation; and (c) accounts of clients who are not United States persons. See Form ADV Adopting Release by clicking HERE.
- You provide **continuous and regular supervisory or management services** with respect to an account if you have: (a) **discretionary authority** over and provide ongoing supervisory or management services with respect to the account; or (b) **non-discretionary authority** over the account for which (1) you have ongoing responsibility to select or make recommendations, and (2) if accepted by the client, you are responsible for arranging or effecting the purchase or sale.
- The value of RAUM is the market value of the assets in your securities portfolios determined within 90 days prior to the date of filing the Form ADV and reflect the market value using the same method used to report account values to clients or to calculate fees for investment advisory services.
- **Do not deduct any outstanding indebtedness or other accrued but unpaid liabilities.**

Special rules for private funds:

- Treat all of the assets of a private fund as a securities portfolio.
- Determine the current market value (or fair value) of the private fund's assets **and include the contractual amount of any uncalled commitment** pursuant to which a *person* is obligated to acquire an interest in, or make a capital contribution to, the *private fund*.

Filing Deadlines

*On March 13, 2020, the SEC issued an order under Section 206A of the Investment Advisers Act of 1940 granting exemptions from specified provisions of the Investment Advisers Act ("Order"). To see a copy of the Order, Click HERE. The Order **applies to filings and delivery obligations due between March 13 and April 30, 2020** (e.g., Form ADV Parts 1A, 2A and Form PF for advisers with a 12/31 FYE) and will allow these deadlines to be extended for up to 45 days if the adviser (both registered and exempt):

1. Is unable to meet the filing deadline or delivery requirement due to circumstances related to the current or potential effect of COVID-19;
2. Promptly provides an email to the SEC (for Form ADV at IARDLive@sec.gov; for Form PF at FormPF@sec.gov) and discloses to investors on its website (if no website then by other means) that:
    - the adviser is relying on the relief provided by the SEC Order;
    - a brief description of the reason why the adviser could not file its Form(s) timely; and
    - the estimated date the adviser expects to file the Form(s); and
3. Files the Form ADV and/or Form PF and delivers the Brochure as soon as practicable, but no later than 45 days after the original due date.

Even though the SEC has provided limited relief to those who can articulate a reason why the adviser is unable to meet the filing deadline, we advise clients to submit the Form ADV by March 30 and the Form PF by April 29 unless the adviser has a factual basis for not being able to meet the deadline (e.g., a principal has been diagnosed with Coronavirus and cannot provide the information necessary

to accurately complete the Form ADV). Any adviser relying on this relief should also be prepared to provide documentation to the SEC to substantiate representations made to the SEC in claiming the relief available under the Order. Any adviser relying on this Order should also be prepared to have its business continuity plan scrutinized by the SEC.

Investment Advisers, Alternative Investment Funds, Alternative Investment Fund Managers

March 15, 2020[1]
- Blue Sky Filings

March 29, 2020[1]
- Distribution of Audited Financial Statements for fund of funds (Fiscal Year Ending 9/30)
- Form ADV Annual Amendment (Fiscal Year Ending 12/31)
- Form MA Annual Amendment (Fiscal Year Ending 12/31 or sole proprietor)
- FATCA Reports

April 10, 2020
- Form 13H Quarterly Update

April 15, 2020
- Form PF (Quarterly Filing for QE 3/31) – Large Liquidity Fund Advisers
- Blue Sky Filings

April 29, 2020
- Annual Form PF
- Distribution of Audited Financial Statements (FYE 12/31)
- Distribution of Updated Form ADV Part 2A (FYE 12/31)

April 30, 2020
- AIFMD Annex IV Quarterly Reporting

May 8, 2020[1]
- Form N-CSR (for annual reports distributed on 4/30)

May 15, 2020
- Form 13F
- Blue Sky Filings
- AIFMD Annex IV Quarterly Reporting for fund of funds

May 29, 2020[1]
- Form PF (Quarterly Filing for QE 3/31) – Large Hedge Fund Advisers

June 15, 2020
- Blue Sky Filings

June 29, 2020
- Form ADV Annual Amendment (FYE 3/31)
- Distribution of Audited Financial Statements for fund of funds (FYE 12/31)

Commodity Pool Operators and Commodity Trading Advisers and Exemptions

March 29, 2020[1]
- February Monthly Account Statements (CPO with NAV over $500,000) – delivered to pool participants
- PQR (CPOs AUM<$1.5 Billion)

April 30, 2020
- March Monthly Account Statements (CPO with NAV over $500,000) – delivered to pool participants
- Quarterly Account Statements (CPO with NAV under $500,000) – delivered to pool participants

May 15, 2020
- Quarterly NFA Form PR

May 29, 2020[1]
- PQR for QE 3/31 (all CPOs)
- April Monthly Account Statements (CPO with NAV over $500,000) – delivered to pool participants

June 29, 20201[1]
- Annual Report – CPO Members (FYE 3/31)

1 For deadlines that fall on a weekend or holiday, Constellation recommends submitting the filings early even though it may be permissible to submit the filings or comply with the regulatory requirement on the next business day.

High-Class Problems: Issues Successful Start-Up Managers Face - Part I

By: Jason P. Grunfeld, Partner, Kleinberg, Kaplan, Wolff & Cohen, P.C.

In recent years, a number of fund managers have launched funds primarily with friends and family money, hoping to develop a track record before targeting larger, institutional investors down the road. It's not the old days when someone with a Bloomberg terminal in their apartment could be successful in scaling the business, so what does a manager need to do after the fund has launched and is putting up impressive performance? In this series, we'll address some of the questions and issues managers face when attempting to grow their fund and make it more attractive to institutional investors.

The first big picture topic many managers should consider is structure. *Does my current structure make sense? What happens if I get close to my investor limit? Do I need an offshore vehicle?* These are all important questions which need to be thought about as a manager contemplates growth of their firm.

For managers who have started their funds on a smaller scale, most have used a simple stand-alone domestic fund structure. In these cases, the fund is typically a 3(c)(1) fund which limits the number of U.S. investors to no more than 100 investors and permits only "accredited investors" to invest in the fund.

As the fund approaches the 100 investor limit, a fund manager has a few options to address this issue. One is for the manager to convert the 3(c)(1) fund to a 3(c)(7) fund, which can accept up to 2,499 investors. Problem solved, right? Not exactly. In order to invest in a 3(c)(7) fund, the investors must all be "qualified purchasers," which is a significantly more onerous standard for investors to meet. Many friends and family do not meet this standard, so they would have to be removed from the fund. Most managers don't want to force their friends and family to withdraw from the fund, especially when they were the initial investors that supported the manager at launch.

The second option is for the manager to launch a new 3(c)(7) fund alongside the existing 3(c)(1) fund and move any investors who are "qualified purchasers" into the new fund. The benefit of this is that friends and family can stay in the existing fund, new slots are opened up in the existing fund, and the new 3(c)(7) fund can take all new investors that meet the qualification standards, allowing the manager to greatly increase the number of investors while not kicking out friends and family.

After a manager has performed well and started to build a track record, one of the other major considerations is the addition of an offshore component to the current fund structure. Setting up an offshore arm allows the fund to accept investments from U.S. tax-exempt investors (pensions, endowments, ERISA investors, etc.) as well

as offshore investors. These investors are not technically prohibited from investing in a U.S.-based fund, but there are tax and other reasons why many of those investors will not typically invest in a domestic fund. For example, if a fund utilizes leverage, tax-exempt investors will be subject to UBTI (unrelated business taxable income), which will negatively impact performance. In addition, many non-U.S. investors do not want to receive a K-1 and show up on the IRS radar.

Once a manager establishes that there is interest in an offshore vehicle, the process is straightforward, but does have several steps that must be taken. The manager will work with their fund lawyer to engage offshore counsel to form an offshore feeder fund as well as a master fund (typically domiciled in the Cayman Islands). The existing fund would then become the domestic feeder in a master-feeder structure, and as an administrative matter, the existing domestic fund documents would need to be revised to reflect that restructuring.

There are also several things to address from an operational perspective before the new structure can be finalized. First, the manager will need to update all of its trading documentation (PB agreements, ISDAs, repos, etc.) as those contracts were drafted when the existing fund was the trading vehicle. With the change in structure, the master fund would now become the trading vehicle, so the agreements must be amended to reflect that. The Administration Agreement will also require updating to add the offshore feeder fund as well as the master fund as parties to that agreement. In addition, the master fund will have to open a new brokerage account, and the existing domestic fund would then need to contribute the positions in its portfolio to the master fund, as all investments will now be held at the master fund level. Once these steps are accomplished, the restructuring is complete and the new structure is ready to launch and accept capital.

While these changes may sound daunting, this is the next step in your evolution as a fund manager, and if you have surrounded yourself with the right partners, it will not be as overwhelming as you might think. Dealing with these issues just means that you have been successful in growing your business and you are ready for the new challenges ahead.

Insider Trading: Second Circuit Holds that a "Personal Benefit" Is Not Required for Insider Trading Under Criminal Securities Statute

By: Jonathan E. Richman, Partner, Proskauer Rose, LLP

**as of March 14, 2020*

The Second Circuit held in late December 2019 that the criminal statute proscribing securities fraud permits convictions for insider trading without proof that the provider of material, nonpublic information ("MNPI") received a personal benefit in exchange for that information, even though proof of a personal benefit would be required under the general securities-law statute prohibiting insider trading. The decision in *United States v. Blaszczak*, 947 F.3d 19 (2d Cir. 2019), if it survives further review, would enable prosecutors to obtain convictions for insider trading while avoiding the potentially complicated "personal benefit" issue, which has generated much litigation in recent years. The ruling does not apply to civil cases.

Background

Insider-trading cases, whether civil or criminal, have traditionally been brought under the general securities-law statute prohibiting securities fraud, 15 U.S.C. § 10(b) ("Title 15"). An insider cannot be convicted of Title 15 securities fraud unless the government proves that he or she breached a duty of trust or confidence by using or disclosing MNPI in exchange for a "personal benefit." Courts also have generally agreed that a recipient of MNPI cannot be convicted of securities fraud unless he or she used the information knowing that it had been obtained in breach of the insider's duty (a standard that includes the tippee's knowledge of the tipper's personal benefit).

In 2014, the Second Circuit sought to tighten the personal-benefit requirement. That ruling triggered a round of reactions and has been significantly diluted by subsequent decisions. In the meantime, though, prosecutors have tried to avoid the burdens and doctrinal confusion involving Title 15 securities fraud by prosecuting insider trading under a specific criminal statute – 18 U.S.C. § 1348 – instead of (or in addition to) under Title 15's general anti-fraud provision. Prosecutors have argued that, whatever Title 15's personal-benefit test might be, it does not apply under Title 18.

Section 1348 imposes criminal liability on anyone who "knowingly executes, or attempts to execute, a scheme or artifice" either (1) "to defraud any person in connection with" any commodity or any security of a registered issuer or (2) "to obtain, by means of false or fraudulent pretenses, representations, or promises, any money or property in connection with the purchase or sale of" any such commodity or security. Because § 1348 is a criminal statute, the SEC cannot use it for civil enforcement actions.

The *Blaszczak* Case

Blaszczak involved prosecutions of four individuals in connection with alleged schemes to obtain nonpublic information from the Centers for Medicare and Medicaid Services (the "CMS") about reimbursement rates for certain medical treatments. A CMS employee had allegedly given MNPI to a friend (Blaszczak), a former CMS employee who was then working as a consultant; the consultant passed the information to persons at two hedge funds, who traded on it.

The government charged all defendants with securities fraud under Title 15 and also with violations of § 1348 and the wire-fraud statute. The court's jury instructions on the Title 15 charge addressed whether the tipper (the CMS employee) had owed and breached any duty of trust or confidence to his agency, whether he had received a personal benefit for doing so, and whether the tippee defendants had known of the tipper's breach of duty and receipt of any benefit. The defendants asked the court to include those same elements in its charge under § 1348, but the court denied the request.

The jury acquitted the defendants of Title 15 securities-fraud violations, but convicted them under § 1348. The Second Circuit, in a 2-1 decision, affirmed.

Second Circuit's Decision

The Second Circuit held that the personal benefit required for Title 15 securities fraud does not apply to Title 18 securities fraud under § 1348 (or to wire fraud under 18

U.S.C. § 1343). This difference exists because Title 15 securities fraud "depends entirely on the purpose of the [Securities] Exchange Act," while Title 18 securities fraud derives from the embezzlement theory of fraud.

According to the majority, "the personal-benefit test is a judge-made doctrine premised on the Exchange Act's statutory purpose," which is "to protect the free flow of information into the securities markets" while "eliminat[ing] [the] use of inside information for personal advantage." Title 18 securities fraud, in contrast is "derived from the law of theft or embezzlement," where a breach of duty (including receipt of a personal benefit) is not an additional prerequisite because "it is impossible for a person to embezzle the money of another without committing a fraud upon him." The breach of duty thus is inherent in the offense.

The court was not moved by the argument that eliminating the personal-benefit requirement from Title 18 securities fraud (and wire fraud) would make insider-trading convictions easier to obtain – even if (as here) the jury acquitted the defendant of Title 15 securities fraud. Rather, the court concluded that § 1348 was designed to achieve that result.

The defendants have petitioned for panel or *en banc* rehearing, with support from *amici* the National Association of Criminal Defense Lawyers, the Alternative Investment Management Association, and a group of law professors. The petition is pending.

Implications

The government's ability to use Title 18 to avoid Title 15's breach-of-duty and personal-benefit requirements facilitates insider-trading prosecutions where the government cannot prove (or does not want to undertake the burden of proving) that the insider received a personal benefit in exchange for providing MNPI – or that remote tippees knew about any such benefit (a particularly difficult standard in cases involving extended chains of tippees). The government has used § 1348 more frequently in recent years, and the *Blaszczak* decision is likely to accelerate that trend.

From a compliance point of view, the existence of this alternative prosecutorial route under § 1348 emphasizes the importance of making compliance judgments based on avoiding use of MNPI, rather than on framing defenses. Focusing on whether MNPI is at issue also avoids potential liability under the European Union's Market Abuse Regulation (the "MAR"), which is more stringent than traditional U.S. insider-trading law. The MAR prohibits use of material information that the user knows or should have known is nonpublic. Questions about the existence and breach of a duty and the receipt of a personal benefit are irrelevant. The MAR applies to all securities admitted for trading on an EU market, even if the trading at issue involves an EU-listed security cross-listed on a U.S. market. Thus a U.S. trader who purchases on a U.S. market a security that is also listed on an EU market might theoretically be subject to the MAR's requirements.

"Alternative Data" and the Operational/ Compliance Issues that Could Come Up When Using it in a Research Process

By: David Umbricht, Managing Director, Shadmoor Advisors

Overview

The utilization of "Alternative Data" as an input into an investment manager's proprietary research process has increased dramatically as the internet and the availability of individual's and corporate datum has made it easier to compile valuable insights and trends, on a near or real-time basis, that can be used to inform a research analyst or a portfolio manager's investment thesis and potentially generate portfolio alpha.

Mortgage information and credit card transaction data are often the first examples that come to people's minds when they think of alternative data. However, the breadth of the types of information within the category is expanding rapidly. Tools, such as web scraping (extracting information from websites through programming automation) have made it easier to create data sets of information that were not previously discernable. While the alpha derived from alternative data should be assessed as part of an investor's investment due diligence, investors must also be aware of some of the operational due diligence related topics that can arise from an investment manager's use of alternative data.

Compliance Concerns/Material Non-Public Information

Perhaps the most vital area an investor should understand is an alternative data provider's data collection policies. Whenever new methods of research emerge, it is important to understand how compliance procedures should be applied or enhanced. The emergence of alternative data today as a key component of the investment management research process is comparable to the way expert networks were initially utilized many years ago. As expert networks became more prevalent in the investment management industry (and as some investment managers found themselves faced with concerns related to exposure to material non-public information due to their dealings with expert networks) compliance best practices evolved. Today, when dealing with expert networks there are ubiquitous "best practices", such as reading scripts at the inception of a call with an expert, recording phone calls with experts and research analysts, having investment management compliance personnel chaperone expert network calls, and forbidding discussions with recent or current employees of publicly traded companies. We expect that alternative data best practices will continue to evolve, as they did for expert network engagements, because of the ongoing risk of being exposed to material non-public information as well as increased focus in individuals' data privacy rights.

Data Privacy Issues

Another area of focus relates to an individual's data privacy. Heightened legal and regulatory focus on personally identifiable information ("PII") through the enactment of GDPR in Europe and the California Consumer Privacy Act in the U.S. add additional layers of regulation that must be considered with respect to the consumption of alternative data. It is important to understand what level of care data providers are taking to ensure that no PII is included in the

alternative data being sold, which could be in violation of these regulations as well as others that are pending or being contemplated in multiple jurisdictions around the globe.

Vendor Due Diligence

The scope of an investment manager's vendor due diligence of its service providers should certainly include its alternative data providers. The ability of the alternative data provider to deliver accurate data from reliable sources in a consistent manner that falls within the scope of what is legally obtainable are important criteria to evaluate. Investors may want to inquire as to how broadly disseminated the data is within the investment management industry, which could potentially make the information less valuable to each marginal consumer of the data. Finally, the control environments at the alternative data providers may vary widely given that the range of providers could include sources as small as one individual to companies with many employees.

Infrastructure/Staffing

Employees with the title of 'data scientist' at an investment manager was largely unheard of until the last few years. Processing and analyzing alternative data can be labor intensive. If a manager wants to embark on a significant effort in using alternative data, they will need an appropriate staffing and experience level. There are multiple functions that are needed in a good alternative data infrastructure, this includes sourcing unique data sets, scrubbing and normalizing the data to prepare it for analysis. The computer processing power necessary to analyze these data sets can be substantial as the data can be enormous with respect to number of records. The location and security around where this data is held and analyzed may not always fall within the confines of the investment manager's traditional file network. Operational due diligence practitioners may want to understand the controls in place related to cybersecurity and access rights with respect to alternative data.

Expenses

As operational due diligence analysts review financial statements and fund terms in fund offering documents, the expenses associated with alternative data are often considered 'research' and therefore may be eligible for inclusion as a fund expense. It's important to consider this when evaluating fund expense ratios and their impact on potential return targets.

Conclusion

Alternative Data is potentially additive to an investment manager's research process. Investors should be aware of their investment managers' policies around the usage of alternative data and include questions related to alternative data as a part of a firm's operational due diligence review of a fund or investment manager. While best practices, with respect to oversight are emerging, we believe the topics covered in this review provide an entry point for how operational due diligence analysts can conduct their reviews in a way that incorporates operational risks related to an investment manger's use of alternative data.

SEC and Cyber Priorities

By: Jason Emler, Managing Partner, and Anthony Patti, Vice-President, Drawbridge Partners, LLC

Due to the danger that cyber-attacks pose in the current climate, agencies such as the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) have notably shifted their primary focus towards cybersecurity issues, and in recent years have been particularly committed to the regular communication of known threats and expectations for firms.

This past January, the SEC via the Office of Compliance Inspections and Examinations (OCIE), released its 2020 examination priorities. As with last year's publication, a specific focus is placed on (1) governance and risk management; (2) access controls; (3) data loss prevention; (4) vendor management; (5) training; and (6) incident response and resiliency. As such, during cybersecurity risk assessment reviews (an exercise all firms should be completing), elevated scrutiny should be afforded to the aforementioned areas identified by the OCIE.

Furthermore, the SEC's Office of Compliance Inspections and Examinations (OCIE) issued a report entitled "Cybersecurity and Resiliency Observations." The OCIE report functions as a summation of combatant industry practices recommended for cybersecurity risks, as well as for the purpose of maintaining and enhancing operational resiliency amongst firms. A substantial portion of the new report is devoted to incident response and resiliency, which encourages the adoption of routine and comprehensive network testing and monitoring on the part of firms to validate the effectiveness of the implemented cybersecurity policies and procedures.

Commitment to cybersecurity is the crux of any fortified firm - it is imperative that firms reflect on their own cybersecurity practices and guarantee that cybersecurity is a priority. Executives must be active in the development, cultivation, and preservation of their firm's comprehensive cybersecurity program. This is accomplished by regularly reevaluating and revising firm policies and procedures to adequately align with the cybersecurity guidelines provided by supervisory governing bodies and trusted security partners, as well as investor operational due diligence initiatives.

A robust, reinforced cybersecurity program extends far beyond an initial pledge to the cause, as it is rooted within the establishment and conservation of an ongoing adherence to the integrity, confidentiality, and availability of secure data. By partnering with an experienced vulnerability management provider, firms are able to construct a cohesive program whilst continually analyzing vulnerabilities in their network, as opposed to simply attempting to detect such vulnerabilities at singular points in time. Ongoing vulnerability management assures firms that they are constantly protected and in compliance with due diligence, regulatory requirements, and industry frameworks.

As included in the OCIE's publication, vulnerability scanning is one of the most effective methods of ensuring that a firm's network and endpoints are secure. It is vital that firms conduct vulnerability scanning on a routine, standardized basis. Firms should implement a vulnerability

management program inclusive of routine scans of servers, workstations, databases, and endpoints. The enactment of a proper vulnerability management program will aid in the remediation of detected vulnerabilities and safeguard firms against the pervasive cyber threat.

Vulnerability management is the proactive process of locating potential weaknesses in a firm's network, and at its core, is aimed at aiding in the remediation of these potential shortcomings before an attacker has an opportunity to manipulate and exploit them in a cyber-attack, whether it be for the purpose of accessing confidential data, installing ransomware on firm devices, etc. Detected network vulnerabilities, however minor, may be indicative of potential holes in a firm's network security. For that reason, firms must institute effective and efficient management programs comprised of, at a minimum, multiple internal and external vulnerability scans throughout a given year, detailed data tracking and remediation guidance, and vulnerability analysis ratings and reports.

While the frequency at which a firm conducts scans on its internal and external networks is, in part, dependent upon the firm's individualized risk appetite/risk tolerance, it is important to consider the increased risks that accompany the lack of a vulnerability management program. Just because a firm's network is determined to be secure and void of vulnerabilities one day does not guarantee that the same will hold true for the next day, and all those that follow.

Above all else, firms must always remember that people are key. In fact, human error is the greatest cybersecurity risk of any firm, for threats from the inside of an organization are often overlooked. Although firms may be able to restrict their sensitive data behind a virtual barbed fence, it only takes one employee clicking on a wrong link or downloading a seemingly legitimate document to render a firm's entire defense system utterly useless. On that account, employee onboarding training and routine security exercise testing thereafter are necessary components of any cybersecurity program.

Electronic Communications – Best Practices for Designing a Robust Surveillance Program

(Part 2 of 2)[1]

By: Michael Abbriano, ACA Compliance Group

In Part 1 of this series, we discussed high-level best practices for designing an electronic communications ("e-comms") surveillance program. In this article, we will cover more granular practices for improving your search techniques in order to find the "needles in the haystacks" among the huge number of e-comms archived by your firms.

Know Your Archival Platform

As with so many other areas in life, you often get what you pay for when it comes to archiving solutions. If e-comms surveillance is going to be a critical part of your compliance program, you should invest in the solution that offers the most robust searching functionality within your budget and you should take the time to understand how to leverage that functionality to enhance your surveillance program. Examples of these advanced search techniques include:

- Boolean logic – i.e., using operators such as "AND," "OR," and "NOT" to refine your searches
- Wildcards – i.e., characters (such as "*" or "?") that can stand in for unknown characters when only part of the search criteria is known
- Proximity searches – i.e., searches that can be used when you expect that certain words will appear in close proximity to each other, but don't know the exact order in which they will appear
- Filtering – i.e., tools that can eliminate certain low-value content (such as newsletters and other blast emails) from your search results

The following illustrates how you might use these advanced searching techniques to craft more effective search terms. This search is intended to identify the potential use of a number of commonly used, non-traditional messaging platforms while filtering newsletters and other "noise" from the search results:

> *["check your" AND (cell OR phone OR IM OR WhatsApp OR WeChat OR Signal OR Confide OR Gmail)]*
> *AND NOT [("click here" OR alert* OR info@ OR undeliverable OR donotreply@)]*

Compare this to the more basic approach of conducting multiple repetitive searches for one platform at a time (e.g., "check your cell," "check your Gmail," etc.), and it is easy how these enhanced searching capabilities can save a significant amount of time.

Jargon

There is no shortage of acronyms, abbreviations, and other jargon in the financial services industry and your search terms should reflect that. This includes industry-wide jargon (e.g., "paper" to describe certain credit instruments) as well as firm-specific jargon (e.g., client short names, abbreviations used to refer to portfolio holdings, etc.). A search for communications containing the phrase "Widget Corp," for example, only tells you part of the story if your employees more commonly refer to Widget Corp. as "Widget" or "WC."

In addition to the inside baseball jargon of the financial services industry, reviewers should have a general awareness of common shorthand used in e-comms more broadly. For example, an exchange about unreported gifts and entertainment may refer to "tix" rather than "tickets" and an exchange about a trade error may begin "wtf was I thinking?" rather than using more colorful language.

Furthermore, for advisers that operate in multiple jurisdictions, regional differences in spelling, slang, etc., should be taken into account. For example, a "rumor" in the U.S. is more likely to be a "rumour" in the U.K. As another example, an adviser based in New York might have more luck finding communications about unapproved gifts and entertainment if they search for "Mets" and "Yankees" in addition to more generic search terms like "tickets."

$#@%!

Potentially inappropriate language, such as swear words and other inflammatory remarks, can be surprisingly effective keywords for e-comms reviews. For a compliance reviewer, the concern is less about the professionalism of the communication (although that may certainly be of interest to other areas of your firm) and more about

what is implied by the use of inappropriate language in a business communication. For example, these types of words and phrases are often used by employees, investors, and others who are upset and, therefore, may be present in communications related to investor complaints and unresolved mistakes or errors. Such language can even reveal potential information security concerns, such as compromised business email accounts.

Misspellings and Alternative Spellings

Unfortunately, misspellings and alternative spellings are rampant in e-comms, which complicates the job of an e-comms reviewer as they can cause communications to be missed if searches are conducted using only one spelling of a search term. Particularly concerning are misspellings or alternative spellings that are used intentionally. While these may arise for benign reasons (see Jargon above), they may also signal an affirmative effort to avoid detection by the firm's e-comms surveillance. An effective surveillance program will take spelling variants into account and the use of Boolean logic (e.g., ["txt" OR "text"]) and/or wildcards (e.g., ["t*xt"]) can be extremely useful in capturing a wider range of spellings for a given search term.

Non-Traditional Communications Platforms

As discussed in Part 1 of this series, non-traditional communications channels (i.e., channels other than firm email and enterprise instant messaging platforms such as Bloomberg) are proliferating. These platforms may include SMS text messaging, social media (such as LinkedIn, SnapChat, etc.), and encrypted and/or "self-destructing" messaging applications (such as Confide, Telegram, etc.).

To the extent that a firm permits the use of non-traditional communications platforms, it is imperative that they have the ability to retain relevant communications as required by applicable books and records rules and to conduct effective supervision of communications sent and received on any platform approved for business use. The ability to retain communications on the most popular platforms is rapidly improving, but this is an emerging area and so particular care should be paid to ensuring that the archival is working as expected.

For platforms that are not approved for business use, it is prudent for the adviser to monitor for evidence of employee use. This can be difficult since the communications are, by definition, not being captured by the adviser, but searching for the names of commonly used messaging platforms may reveal the existence of such communications even if the reviewer cannot see the communications themselves. Additionally, searching for phrases such as "let's take this offline" or "did you see my message" can be effective at identifying communications that are taking place on an unapproved channel even in instances where the name of the channel is unfamiliar to the reviewer or is not referenced directly in the communication.

1 To read Part 1, please see our December 2019 Report

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