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These Are Volatile Times: What Asset Managers Need to Know—and Do—When SEC Comes Calling

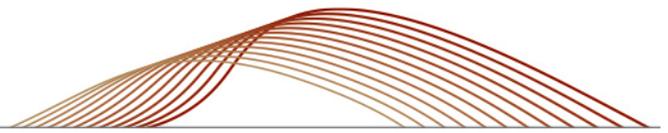
By [Nick Morgan](#), [John P. Nowak](#), [Vadim Avdeychik](#) & [Alexandra Marghella](#)

During this unprecedented time of market volatility, asset managers should be prepared for potential inquiries from the Securities and Exchange Commission staff (“SEC” or the “Commission”). The inquiries may range from general inquiries regarding what steps asset managers are taking to deal with market volatility to more specific inquiries regarding liquidity of specific investment strategies and the status of client redemptions. Specifically, SEC inquiries reflect its recent announcement that the Commission is “closely monitoring the impact of the coronavirus on investors, funds and advisers” and “the Commission and its staff continues to assess impacts relating to the coronavirus on investors and market participants.”¹ As a result, asset managers should, among other things, be prepared to address inquiries from the SEC and should identify appropriate internal resources responsible for responding to SEC inquiries.

SEC’s Focus on and Access to Data

Since the last financial crisis the Commission has passed several reporting mandates that require asset managers to provide information to the Commission with respect to the portfolios and investment strategies that they oversee. These new reporting requirements were passed in order to ensure that the Commission has access to the relevant data so the SEC’s staff can better monitor various segments of the market. For example, on October 13, 2016, the SEC adopted, among other things, new Forms N-PORT and N-CEN, to enhance transparency and modernize reporting requirements for registered investment companies. Among other things, Form N-PORT requires portfolio-level information that facilitates risk analyses and other SEC oversight. For example, Form N-PORT requires reporting of certain risk-metric calculations that measure a fund’s exposure and sensitivity to changing market conditions, such as changes in asset prices, interest rates, or credit spreads.

In addition, since the financial crisis, the Commission has also passed amendments to Form ADV and adopted Form PF in order for asset managers to provide information to the SEC with respect to the private funds that they manage. Form PF is designed to, among other things, assist the SEC in its assessment of risks in the U.S. financial system. Moreover, in 2009, the SEC created the Division of Economic and Risk Analysis (“DERA”). DERA was created to integrate financial economics and rigorous data analytics into the core mission of the SEC. Among other things, DERA develops customized, analytic tools and analyses to proactively detect market risks indicative of possible violations of the



Federal securities laws. Using data, DERA staff creates analytic programs designed to detect patterns identifying risks, enabling Commission divisions and offices to deploy resources targeting possible misconduct.

Collectively, the regulatory steps taken by the SEC since 2008 reflect the SEC's focus on and access to data. With recent market volatility, we believe the SEC will use the data to focus their next set of examinations, informal inquiries, and potentially, enforcement actions.

If the SEC Staff Comes Calling

Historically, when the SEC staff came calling they focused on a particular investment strategy or money manager. For example, in 2015 when the Third Avenue Focus Credit Fund announced that no further subscriptions or redemptions of fund shares would be permitted and liquidation of the assets in the liquidating trust would be expected to take up to a year or more, the SEC followed up with requests to other asset managers managing similar investment strategies inquiring about the liquidity of their funds and the impact that the liquidation of the Third Avenue mutual fund may have on their funds and the distressed debt market in general.

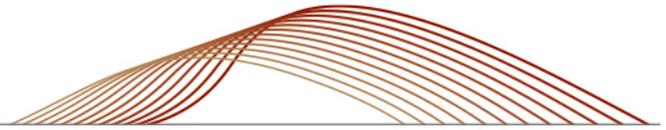
When the markets are volatile, however, the SEC may inquire about more general matters – views on market volatility, status of client redemptions, liquidity issues, and liquidity issues with counterparties. These types of communications should not be a cause for alarm – the SEC is conducting this outreach to better monitor the markets and understand market risks at a macro level. However, every money manager should prepare for this type of outreach in advance.

If the SEC staff does make inquiries, an asset manager should, among other things:

- Determine the scope of the SEC's inquiry (most initial inquiries are informal and are designed to be fact gathering, but managers should determine whether questions from the Office of Compliance Inspections and Examinations ("OCIE") are part of an examination or questions from the Enforcement Division are part of a formal investigation);
- Set up a response team that includes the chief compliance officer, chief risk officer, and the investment professionals responsible for the particular investment strategy;
- If applicable, discuss the response with the board of directors of a fund;
- Prepare for follow-up requests and potentially a formal examination letter; and
- Review applicable policies and procedures.

How to Avoid Potential Issues

The easiest way to avoid potential issues if the SEC comes knocking is to adhere to, and follow, existing policies and procedures. If designed correctly, policies and procedures should account for volatile situations. Often times, issues arise when the stresses of a volatile market cause an organization to operate in a manner that is inconsistent with its designed policies. The SEC will pay particular attention to any circumstances that suggest an inconsistent approach to firm policy – and there is a risk that any inquiry by the SEC into such circumstances will lead to a more formal process, including an examination.



If in-house legal and compliance counsel are considering any modification of policies or procedures in response to these volatile markets, or if there are questions about the strength and design of existing policies, it is best to consult outside counsel who might offer a different perspective based on insight gained from a variety of similarly situated clients.

To Sum It Up

With no signs that the recent market volatility will abate in the near future, asset managers must be proactive in addressing the legal and compliance risks that are associated with their investment strategies. Those who ignore addressing legal and compliance risks, and operate in a manner inconsistent with firm policies, run the risk of reputational damage and regulatory scrutiny.



If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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¹ SEC Takes Targeted Action to Assist Funds and Advisers, Permits Virtual Board Meetings and Provides Conditional Relief from Certain Filing Procedures, <https://www.sec.gov/news/press-release/2020-63> (March 13, 2020).

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