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Private Fund Managers: Navigating Recent SEC Guidance on Custody Rule, Qualified Client Status, Knowledgeable Employees, Social Media and CCO Liability

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Developments Impacting Private Equity Fund Managers

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SEC Presence Exams

Dodd Frank changed the regulatory environment for managers of private equity funds and other private investment vehicles by eliminating the “private adviser” exemption, resulting in the registration of private fund managers as investment advisers under the Investment Advisers Act of 1940 (Advisers Act).

On October 9, 2012, the Office of Compliance Inspections and Examinations (OCIE) of the Securities and Exchange Commission (SEC) announced a new program called the Presence Exam Initiative for these newly registered advisers.

Presence Exams involve focused, risk based examinations of advisers to private funds.

SEC Presence Exams

The SEC's Presence Exam Initiative has three components:

- engagement-outreach to inform newly registered fund managers of their obligations under the Advisers Act and related rules
- examinations –targeting higher risk areas of the business and operations of private fund managers
- reporting – providing information concerning exam findings

SEC Presence Exams

Presence Examinations-targeted risk areas

- marketing
- portfolio management
- conflicts of interest
- safety of client assets- custody rule issues
- valuation

SEC Presence Exams

Presence Exams-Process

The process involved in SEC Presence Exams is essentially the same as in regular OCIE compliance examinations, except that the focus is narrower and the overall time frame is generally shorter

- communication from OCIE that there will be a Presence Exam,
- document request – including email
- production of requested documents
- on-site examination and interviews
- exit interview
- silence – deficiency letter – or enforcement referral

SEC Presence Exams

The Presence Exam Initiative has resulted in a number of statements by the SEC concerning items coming to light in the exams, including

- Broker –dealer issues
- Custody issues
- Fees and transparency issues

As of May 6, 2014, the SEC had initiated more than 150 examinations of newly registered private equity advisers. SEC personnel have stated that the SEC is on track to complete its goal of examining 25% of the new private fund manager registrants by the end of 2014.

Custody Rule – General

- Managers of private equity funds and other private investment funds that are registered as investment advisers with the SEC under the Advisers Act are required to comply with Rule 206(4)-2, known as the custody rule.
- Ensuring compliance with the custody rule, set forth in Rule 206(4)-2 of the Investment Advisers Act (Advisers Act), continues to be a high priority for the SEC. In addition to listing safety of client assets as an examination priority, on March 4, 2013, OCIE published a Risk Alert and Investor Bulletin detailing widespread non-compliance by advisers with various elements of the rule. During examinations, the staff found the following significant deficiencies:
  - Failure by fund managers to recognize if and how the custody rule applies to their business operations;
  - Lack of true "surprise" audits by independent auditors (if relying on that provision);
  - With respect to audits of pooled investment vehicles, the auditor was not "independent" under Regulation S-X, the audited financial statements were not prepared in accordance with GAAP and were not distributed to all fund investors within 120 days of the end of the funds' fiscal year (or 180 days for fund of funds), and a final audit was not performed on liquidated funds; and
  - Failure to satisfy several rule provisions concerning the use of a "qualified custodian," including commingling of firm and client assets, and the manner in which the custodial accounts were held.

Custody Rule – General

- The custody rule applies to private fund managers who are registered as investment advisers at the federal level, and specifies a number of requirements that apply when an adviser has custody of advisory client funds or securities.
- For this purpose, pooled investment vehicles, such as private equity funds and other private investment funds managed by a fund manager registered as an investment adviser, are considered to be advisory clients of the fund manager, and the fund manager generally is considered to have custody of the assets of those private funds.
- Fund managers are exempt from many of the custody rule requirements if they comply with the audit provision of the custody rule with respect to their managed private funds.

Custody Rule – Audit Provision

- The audit provision requires, among other things, that:
  - the private fund be audited at least annually by an independent public accountant registered with, and subject to regular inspection by, the PCAOB; and
  - the audited financial statements be distributed to all beneficial owners of the private equity fund within 120 days of the fiscal year-end of the fund, or within 180 days of the fiscal year-end for a fund of funds (Rule 206(4)-2(b)(4)).
- Generally speaking, most fund managers choose to comply with the audit provision.
- A fund manager who does not rely on the audit provision must, among other things:
  - obtain an independent verification of the funds and securities of each private fund managed; and
  - have a reasonable basis for believing that the qualified custodian sends quarterly account statements to each beneficial owner of the private equity fund (Rule 206(f)-2(a)(2)-(5)).
- The custody rule does not apply to exempt reporting advisers.

Custody Rule – Guidance on SPVs and Escrows

- In IM Guidance Update No. 2014-07, June 2014, the SEC's Division of Investment Management provided guidance on applying the custody rule to two common scenarios that arise in the structuring of investments and dispositions by private equity funds and other private investment funds:
  - The use of special purpose vehicles (SPVs) for making investments
  - The use of escrow accounts when selling interests in portfolio companies

Custody Rule – SPV Guidance

- Private equity funds and other private investment funds often use special purpose vehicles (SPVs) to facilitate making portfolio investments. These SPVs often are wholly owned by one or more funds managed by the same fund manager, though in some situations there also may be outside investors in an SPV that are not funds managed by the fund manager (and thus are not advisory clients of the fund manager within the meaning of the Advisers Act).
- The SEC, in adopting the custody rule, stated that a fund manager could treat:
  - an SPV as a client separate and apart from the related private funds, or
  - the assets of an SPV as assets of the related private funds.

Custody Rule – SPV Guidance

- In situations where a fund manager treats an SPV as a separate advisory client under the custody rule, the fund manager must comply separately with the custody rule's audited financial statement distribution requirements. The fund manager:
  - must have the SPV audited, and
  - must distribute the audited financial statements of the SPV to the beneficial owners of the private funds that own the SPV.
- In situations where a fund manager treats an SPV's assets as assets of the private fund that owns the SPV, the SPV's assets must be considered within the scope of the financial statement audit of the related private funds.
- This treatment generally involves including the assets and liabilities of the SPV in the financial statements of the private fund that owns the SPV and results in footnote disclosure concerning the SPV. However, a separate audit of the SPV is not necessary.

Custody Rule – SPVs Owned Solely by Managed Funds

- The SEC's guidance addresses three common scenarios that arise in the use of SPVs by private equity and other private fund managers, and clarifies that the assets of an SPV can be included in the audit of the applicable fund in each scenario:
  - One private fund creates an SPV for a single investment.
  - One or more private funds invest in an SPV that holds a single investment.
  - One or more private funds invest in an SPV that holds multiple investments.
- In each case, this guidance applies only if the SPV has no owner other than the private fund manager, the manager's related person(s), or private funds managed by the fund manager or the fund manager's related person(s).

Custody Rule – SPVs Owned by Managed Funds and Third Parties

- Another common scenario in the use of SPVs by private fund managers is to establish an SPV through which one or more private funds managed by the fund manager invest, but in which third-party investors also invest. In this scenario, the SPV has third-party owners other than the fund manager, the fund manager's related person(s), or the fund manager's private fund clients.
- The SEC guidance states that **in this scenario, the SPV must be treated as a separate client for purposes of the custody rule**. Therefore, a fund manager seeking to comply with the audit provisions of the custody rule must have the SPV separately audited and comply with the custody rule's audited financial statement distribution requirements with respect to the SPV.

Custody Rule – Escrow Guidance

- Escrows frequently are used in connection with the sale of a portfolio company owned by one or more private equity funds or other private funds managed by a registered investment adviser.
- Where there are multiple sellers, as part of the sale or merger, the sellers (including the private funds and the other owners of the portfolio company) often appoint a “sellers’ representative” to act on their behalf with respect to a portion of the sale proceeds held in an escrow after the closing.
- The escrow generally holds a percentage of the sale proceeds to be used in the event of indemnification or an adjustment of the sale price of a portfolio company, as required by the transaction agreement.
- An escrow typically lasts for a limited period of time and the funds remaining after such time are distributed based on a predetermined formula to the sellers, including the applicable private equity funds.

Custody Rule – Escrow Guidance

- Application of the custody rule to this type of escrow arrangement generally would require that the portion of the escrow applicable to the private fund be held in a separate escrow account for the benefit of only that private fund, rather than in a commingled escrow account for the benefit of all of the sellers.
- The guidance provides that a private fund manager can participate in a commingled, post-sale escrow account without violating the custody rule if:
  – the private fund relies on the audit provision and includes the portion of the escrow attributable to the fund in its financial statements;

Custody Rule – Escrow Guidance

- the escrow is in connection with the sale or merger of a portfolio company owned by the fund (i.e., for indemnification or to adjust the purchase price);
- the escrow amount is agreed upon as part of a bona fide negotiation between the buyer and the sellers;
- the escrow exists for a period of time that is agreed upon as part of a bona fide negotiation between the buyer and the sellers;
- the escrow is maintained by a qualified custodian; and
- the sellers' representative is contractually obligated to promptly distribute the funds remaining in the escrow at the end of the escrow period based on a predetermined formula to the sellers, including the private equity fund.

Custody Rule – Escrow Guidance

- Private fund managers may wish to take this guidance into account in structuring escrow arrangements in connection with portfolio company dispositions.

Custody Rule – Privately Offered Securities

The Advisers Act custody rule, Rule 206(4)-2, requires advisers to audited pooled investment vehicles to maintain with a qualified custodian certain instruments evidencing the pool’s ownership of certain privately issued securities – namely, non-transferable stock certificates or “certificated” LLC interests – that were obtained in a private placement (“private stock certificates”).

Securities which meet the custody rule’s definition of “privately offered security,” do *not* have to be held at a qualified custodian.

A security evidenced by a private stock certificate does not technically meet the custody rule’s definition of “privately offered security” because of the existence of a “certificate.”

Custody Rule – Privately Offered Securities

However, such securities are similar in all material respects to a privately offered security because the client's ownership interest in the security is not impacted by the existence (or lack thereof) of the certificate.

In addition, ownership of these securities is recorded on the books of the issuer or its transfer agent in the name of the pooled investment vehicle and the certificate cannot be used to effect a change in beneficial ownership of the security for which the private stock certificate is issued.

Also, a private stock certificate can be replaced by the issuer if lost or destroyed because ownership is recorded on the books of the issuer.

Custody Rule – Privately Offered Securities

In IM Guidance Update No. 2013-04, August 2013, the SEC's Division of Investment Management stated that it would not object if an adviser does not maintain private stock certificates with a qualified custodian, provided that:

- the client is a pooled investment vehicle that is subject to a financial statement audit in accordance with paragraph (b)(4) of the custody rule;
- the private stock certificate can only be used to effect a transfer or to otherwise facilitate a change in beneficial ownership of the security with the prior consent of the issuer or holders of the outstanding securities of the issuer;
- ownership of the security is recorded on the books of the issuer or its transfer agent in the name of the client;
- the private stock certificate contains a legend restricting transfer; and
- the private stock certificate is appropriately safeguarded by the adviser and can be replaced upon loss or destruction.

Fees and Expenses

Andrew J. Bowden, director of OCIE, gave a speech on May 6, 2014, which discussed findings concerning private equity managers arising out of the SEC’s Presence Exam Initiative.

Bowden indicated that when OCIE examined how fees and expenses are handled by private equity fund managers, OCIE identified what it believes to be violations or material weaknesses in controls more than 50 percent of the time.

Fees and Expenses

This speech is important to private equity industry members because it is clear that the SEC made this information public to encourage private equity fund managers to enhance their focus on compliance in these areas. Bowden stated that

- “it’s fair to say that there’s more work to be done in the private equity industry to bring controls and disclosures in line with existing requirements and investor expectations.”

Bowden also emphasized the importance of a strong culture of compliance, one that is supported by the owners, principals and managing directors of the private equity fund manager, and reinforced by an independent compliance department that is empowered as well as integrated into the business of the fund and the manager.

Fees and Expenses

Accordingly, private equity fund managers may wish to review their practices, with respect to fees and expenses, and determine whether:

- fees and expenses are properly allocated to the manager or the fund;
- full disclosure is being made to investors concerning the allocation and payment of fees and expenses; and
- internal controls, such as accounting and regulatory compliance policies, adequately deal with these issues.

Fees and Expenses – Background

Many of the compliance risks that Bowden highlighted grow out of relationships that private equity fund managers (or their affiliates) have with portfolio companies. Bowden contended that, because a private equity fund manager usually obtains a controlling interest in a portfolio company, there is a resulting conflict of interest on the part of the private equity fund manager in terms of services provided to, and fees and expenses charged to, its portfolio companies.

Fees and Expenses – LPA Provisions

Bowden believes that the governing document for the private equity fund, such as the limited partnership agreement (or LPA), often contains relatively broad provisions concerning the fees and expenses that the manager can charge to portfolio companies.

This lack of specificity in the LPA has

- "created an enormous grey area, allowing advisers to charge fees and pass along expenses that are not reasonably contemplated by investors."

Poor disclosure in this area is a frequent source of exam findings.

In addition to the problems with fee and expense provisions in the LPA, Bowden indicated that LPAs often do not provide limited partners with sufficient information rights, and also are deficient in the areas of valuation procedures, investment strategies and protocols for mitigating conflicts of interest.

Fees and Expenses – The Impact of Industry Trends

OCIE sees private equity industry trends producing three fact patterns that frequently result in enhanced risk for compliance issues:

- zombie funds,
- larger funds resulting from consolidation, and
- reduced investment returns.

Zombie fund managers are unable to raise additional funds and continue to manage legacy funds long past their expected lives. These managers may increase monitoring fees, shift expenses to the fund or push the envelope on valuations.

Fees and Expenses – The Impact of Industry Trends

Industry consolidation in the private equity space is producing the second fact pattern mentioned in the speech as creating governance and compliance issues. For example, much of the growth in private equity is a result of the trend toward using separate accounts and side-by-side co-investments. OCIE is seeing situations where broken deal expenses and other costs associated with generating deal flow are not being allocated to these separate accounts and side-by-side arrangements.

In addition, as returns compress, there is heightened risk that managers will try to make up the shortfall in revenue by collecting additional fees by shifting expenses to their funds.

Fees and Expenses – Problematic Areas

Shifting Expenses to Portfolio Companies. Bowden stated that some of the most common deficiencies occur in the use of special consultants (sometimes called operating partners), who are paid directly by portfolio companies without sufficient disclosure to investors. According to Bowden, these consultants/operating partners are presented to investors as part of the manager's team, but they are not treated as employees or affiliates of management in terms of fee payments.

Fees and Expenses – Problematic Areas

The second expense-shifting pattern identified by Bowden involves transferring expenses from the private equity fund manager to investors during the middle of a fund's life, by terminating employees and bringing them back as consultants/operating partners. This includes billing funds for typical back-office manager functions − such as compliance, legal and accounting − without disclosure.

The third expense-shifting fact pattern discussed involves process automation by the private equity fund manager, with the cost of the automation process paid by the fund, rather than by the manager.

Fees and Expenses – Problematic Areas

Hidden Fees. OCIE is also citing private equity fund managers for various types of fees that either are not disclosed or are inadequately disclosed to investors. Bowden pointed to several fact patterns involving fees in this regard:

- accelerated monitoring fees;
- undisclosed administrative fees not contemplated by the LPA;
- charging transaction fees exceeding the limits in the LPA;
- charging transaction fees not contemplated by the LPA (such as for recapitalizations); and
- hiring related-party service providers, who deliver services of questionable value.

Marketing and Valuation Issues

A common valuation issue identified by Bowden is the use of a different valuation method than the method disclosed to investors. According to Bowden, OCIE examiners are on the lookout for:

- Cherry-picking comparables or adding back inappropriate items to EBITDA, especially costs that are recurring and persist after a strategic sale – if there are not good reasons for the change, and/or, if there is insufficient disclosure to alert investors.

- Changing the valuation methodology from period to period without additional disclosure.

Marketing and Valuation Issues

OCIE also is reviewing marketing materials to identify inconsistencies and misrepresentations, with a particular focus on performance marketing, which uses projections rather than actual valuations without adequate disclosure, and misstatements about the investment team.

Of specific concern to OCIE in this regard are situations where key team members resign or announce reduced roles after a fundraising is completed. In these situations, OCIE will question whether the manager knew about these changes, but failed to disclose them before closing the fundraising.

Knowledgeable Employees

Knowledgeable employees can invest in qualified purchaser (QP) funds without meeting the QP financial requirements (generally $5 million in investments for individuals). In addition, knowledgeable employees do not count against the 100-holder limit in a C1 fund.

The SEC issued an interpretive letter to the Managed Funds Association (MFA) on February 6, 2014 providing favorable interpretations of the concept of a knowledgeable employee.

The MFA letter expands the number of situations where employees of private fund managers will be considered to be knowledgeable employees.

Knowledgeable Employees – Summary

Knowledgeable employee status generally depends on

- being an executive officer of a principal business unit
- performing policymaking functions; or
- participating in the investment activities of the fund.

Executive Officers of a Principal Business Unit

The SEC's usual definition of "executive officer" has created uncertainty when applied to fund managers because that definition is based on an operating company concept.

The MFA letter expands the concept of a principal business unit to include departments not traditionally considered principal business units (such as information technology and investor relations) under certain circumstances discussed in more detail below.

Knowledgeable Employees – Summary

Employees Who Perform Policymaking Functions

These types of employees generally are considered to be knowledgeable employees. The MFA letter confirms that this status does not depend on any particular title and that this status can result from participation in a group (typically a committee) that performs policymaking functions.

Participation in Investment Activities

Employees who participate in investment activities are generally considered to be knowledgeable employees. The MFA letter discusses several situations which have created uncertainty under current interpretations of the concept, including research analysts, risk analysts, tax professionals and lawyers.

Knowledgeable Employees – Summary

Separate Accounts

The MFA letter confirms that the knowledgeable employee status of persons involved in managing separate accounts will be analyzed in a manner similar to that of employees involved in managing private funds.

Affiliated Funds

The MFA letter confirms that employees who are knowledgeable employees with respect to a fund manager which is part of a controlled fund complex using the combined registration format contemplated in the January 18, 2012 letter to the American Bar Association (ABA letter), would generally be considered to be knowledgeable employees for all funds in the controlled fund complex.

Knowledgeable Employees – Documentation

Private fund managers should document the basis for any decision to treat an employee as a knowledgeable employee and should retain that documentation in their books and records.

Knowledgeable Employees – Rule 205-3 – Qualified Clients

Rule 205-3 of the Advisers Act also contains provisions which are intended to permit knowledgeable employees to invest in funds which involve "performance fees," such as the typical carried interest even if they do not satisfy the financial tests to be qualified clients.

The language in the applicable Investment Company Act rule, Rule 205-3, is slightly different from the language in Rule 3c-5.

The MFA letter does not state whether the interpretations in the MFA letter also apply to Rule 205-3. However, the logic behind the interpretations in the MFA letter should also apply to 205-3, or else the MFA letters would have little practical effect, because so many funds have performance fees.

The SEC staff has confirmed by phone that the analysis in the MFA letter should also apply in determining qualified client status in Rule 205-3.

Knowledgeable Employees – Accredited Investor Definition Unchanged

The MFA letter does <u>not</u> resolve another important issue:

- whether knowledgeable employees should automatically be treated as accredited investors or have to meet the financial tests in Regulation D.

So far, the SEC has not taken this position, and the MFA letter does not deal with this issue.

It is possible for an employee of the fund manager to qualify as a knowledgeable employee but not be an accredited investor. This scenario may preclude the use of 506c and may require a 506b offering to non-accrediteds implicating the disclosure requirements in Regulation D.

Knowledgeable Employees – Executive Officers

Executive Officers and Policymaking Employees

“Knowledgeable employee” includes any natural person who is an executive officer of a private fund or an affiliated manager of a private fund (“Affiliated Management Person”). The term “executive officer” means

- the president, any vice president in charge of a principal business unit, division or function (such as sales, administration or finance);
- any other officer who performs a policymaking function; or
- any other person who performs similar policymaking functions for a private fund or for an Affiliated Management Person.

Knowledgeable Employees – Executive Officers

The application of these concepts to investment managers has generated uncertainty in a number of situations. One of these uncertainties has been whether various functions associated with private investment vehicles would be considered to be principal business units for the purpose of this definition.

Knowledgeable Employees – Principal Business Unit

The MFA letter confirms that

- the principal business unit status of a division or function depends on the relevant facts and circumstances of a particular investment manager’s business operations;
- whether a business unit, division or function qualifies as a principal business unit, division or function should be determined through an analysis by the investment manager of the relevant facts and circumstances regarding the investment manager’s business operations;
- several business units, divisions or functions within an investment manager’s business operations may each be considered a principal unit, division or function;

Knowledgeable Employees – Principal Business Unit

- while not all business units, divisions or functions are necessarily principal, it is possible that several business units, divisions or functions could each be principal units, divisions or functions, depending on the facts and circumstances;
- the unit, division or function need not be part of the investment activities of a private fund to be considered a principal unit, division or function; and
- the size of a particular department is not determinative as to whether a function should be considered principal.

Knowledgeable Employees – The IT Department Can Be a Principal Business Unit

The MFA letter confirms that an information technology (IT) department may be considered to be a principal business unit where:

- an investment manager employs one or more technologically driven trading models, and the IT professionals are charged with building the models and systems that translate certain quantitative signals into trade orders; and
- an investment manager employs technology professionals to build performance and risk monitoring systems that interact with the investment program.

Knowledgeable Employees – The Investor Relations Department Can Be a Principal Business Unit

The MFA letter also confirms that the investor relations department can be considered to be a principal business unit where an investment manager relies on investor relations personnel to:

- conduct substantive portfolio reviews with investors, and
- respond to substantive due-diligence inquiries from institutional investors and consultants.

However, an investor relations function would not have principal business unit status where the department merely assists in arranging meetings between an investment manager’s investment staff and prospective investors, disseminates investor communications written by senior executives outside of the investor relations department, or performs administrative tasks.

Knowledgeable Employees – Policy Making Employees

The concept of a knowledgeable employee includes any officer who performs a policymaking function and any other person who performs similar policymaking functions on behalf of an investment manager. A policymaking individual does not need to have a specific title, and the concept of a knowledgeable employee includes all employees who have the power to make and do make policy on behalf of the investment manager, the private fund or an Affiliated Management Person.

The MFA letter confirms that an employee who does not have a senior manager title, depending on the facts and circumstances, may still be considered an executive officer under the rule if he or she makes policy through day-to-day involvement in the development and adoption of an investment manager's policies.

Knowledgeable Employees – Policy Making Employees

Significantly, the MFA letter also confirms that the policymaking function need <u>not</u> be concentrated in one individual and that employees serving as active members of a group or committee who develop and adopt an investment manager's policies, such as the valuation committee, could be executive officers under the rule.

However, individuals who merely observe committee meetings or simply provide information or analysis to the decision makers of a committee or group would not be engaged in making policy and therefore generally would not be executive officers.

Knowledgeable Employees – Employees Who Participate in Investment Activities

The concept of a knowledgeable employee includes any employee of a private fund or an Affiliated Management Person who, in connection with his or her regular functions or duties, participates in the investment activities of the private fund, other private funds or investment companies whose investment activities are managed by the Affiliated Management Person, provided that such employee has been performing such functions and duties for or on behalf of the private fund or the Affiliated Management Person of the private fund, or substantially similar functions or duties for or on behalf of another company for at least 12 months (“Participating Employee”).

Knowledgeable Employees – Employees Who Participate in Investment Activities

Previously, while stating that certain types of nonexecutive employees would not generally be knowledgeable employees because they were not participating in investment activities, the SEC staff stated that some research analysts (e.g., a research analyst who researches all potential portfolio investments and provides recommendations to the portfolio manager) would be knowledgeable employees.

The MFA letter confirms that a research analyst who researches only a portion of the portfolio of a private fund and provides analysis or advice to the portfolio manager with respect to that portion of the private fund's portfolio is participating in the investment activities of the private fund and could be a knowledgeable employee.

Knowledgeable Employees – Employees Who Participate in Investment Activities

The MFA letter also confirms that individuals in the following factual scenarios could be considered Participating Employees because they participate in investment activities (provided they regularly perform those functions or duties and have been doing so for at least 12 months):

- a member of the analytical or risk team who regularly develops models and systems to implement the private fund’s trading strategies by translating quantitative signals into trade orders or providing analysis or advice that is material to the investment decisions of a portfolio manager (in contrast to someone who merely writes the code to a program used by the portfolio manager);

Knowledgeable Employees – Employees Who Participate in Investment Activities

- a trader who regularly is consulted for analysis or advice by a portfolio manager during the investment process and whose analysis or advice is material to the portfolio manager's investment decisions based on the trader's market knowledge and expertise (in contrast to a trader who simply executes investment decisions made by the portfolio manager);

Knowledgeable Employees – Employees Who Participate in Investment Activities

- a tax professional who is regularly consulted for analysis or advice by a portfolio manager, typically before the portfolio manager makes investment decisions, and whose analysis or advice is material to the portfolio manager’s investment decisions, such as when a tax professional’s analysis of whether income from an offshore fund’s investment may be considered “effectively connected income” and is material to a portfolio manager’s decision to invest in certain debt instruments (in contrast to a tax professional who merely prepares tax filings);

Knowledgeable Employees – Employees Who Participate in Investment Activities

- an attorney who regularly analyzes legal terms and provisions of investments and whose analysis or advice is material to the portfolio manager’s investment decisions, such as where the attorney’s legal analysis of tranches of a distressed debt investment is material to a portfolio manager’s decision to invest in the loan (in contrast to an attorney who negotiates agreements that effectuate transactions evidencing the investment decisions of the portfolio manager or an attorney or compliance officer who evaluates whether an investment is permitted under the fund’s governing documents).

Knowledgeable Employees – Separate Accounts

In some cases, employees of an Affiliated Management Person also participate in the investment activities of separate accounts (or a portfolio, or a part of a portfolio, of a separate account) for clients that are "qualified clients" and are otherwise eligible to invest in private funds advised by the Affiliated Management Person and whose accounts pursue investment objectives and strategies that are substantially similar to those pursued by one or more of those private funds ("Covered Separate Accounts").

The MFA letter confirms that an employee of an Affiliated Management Person who participates in the activities of Covered Separate Accounts (or a portfolio, or a part of a portfolio, of a Covered Separate Account) can also be treated as a knowledgeable employee.

Knowledgeable Employees – Employees of Related Advisers in Control Relationships

In the ABA letter, the SEC permitted the managers of affiliated private fund complexes to file a single Form ADV to register all affiliated managers under specified circumstances which involve a single advisory business.

The MFA letter applies the same analysis to the concept of knowledgeable employee.

Knowledgeable Employees – Control Relationships

The ABA letter procedure involves the filing of an ADV by one of the fund managers in the complex, and the other fund managers in the fund complex are described in the ADV. The fund manager who files the ADV is known as the filing adviser, and the other managers included in the ADV are known as relying advisers. This procedure eliminates the need for all fund managers in a controlled fund complex to file separate ADVs.

Accordingly, the MFA letter confirms that if a filing adviser and its relying adviser(s) collectively conduct a single advisory business as described in the ABA letter, then the filing adviser and each of the relying adviser(s) may be an Affiliated Management Person of a private fund.

Knowledgeable Employees – Control Relationships

As a result, knowledgeable employees of a filing adviser or any of its relying advisers may be treated as knowledgeable employees with respect to any private fund managed by the filing adviser or its relying advisers, provided that the employees meet the other conditions of the rule.

Qualified Clients – Aggregation of Accounts

In IM Guidance Update 2013-10, November 2013, the Division of Investment Management provided guidance concerning the status of certain private fund investors as “qualified clients” under Advisers Act Rule 205-3 with respect to fund managers that operate a “single advisory business” through related investment advisers formed as separate legal entities that are registered jointly with the Commission in reliance on the ABA letter (each group, a “Firm”).

Qualified Clients – Aggregation of Accounts

The guidance deals with the aggregation of the investments of certain investors when determining whether the investors are qualified clients as defined in rule 205-3. In these cases the related investment advisers that comprise a Firm collectively advise two or more different private funds, each with its own investors.

When determining if an investor is a qualified client as defined in rule 205-3 and is therefore eligible to be charged performance-based compensation, may the manager aggregate the investor's investments in all of the private funds advised by the related investment advisers that comprise the Firm?

An investor may have invested less than $1,000,000 in any one private fund, but more than $1,000,000 collectively in the private

Qualified Clients – Aggregation of Accounts

Funds advised by the related investment advisers that comprise the firm.

In this situation, consistent with the operation of a single advisory business as described in the ABA letter, the SEC staff stated that it would not object if the firm aggregated the investor’s investments in all of the private funds advised by the related investment advisers that comprise the Firm when determining if the investor has at least $1,000,000 “under the management of the investment adviser,” and thus is a qualified client as defined in Rule 205-3.

Social Media – Testimonial Rule

The rules under the Advisers Act prohibit the use of testimonials in advertisements, Rule 206(4)-1(a)(1). Section 206(4) generally prohibits any investment adviser from engaging in any act, practice or course of business that the SEC, by rule, defines as fraudulent, deceptive or manipulative. In particular, Rule 206(4)-1(a)(1), known as the testimonial rule, states that:

> *[i]t shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business…for any investment adviser registered or required to be registered under [the Advisers Act], directly or indirectly, to publish, circulate, or distribute any advertisement which refers, directly or indirectly, to any testimonial of any kind concerning the investment adviser or concerning any advice, analysis, report or other service rendered by such investment adviser.]*

Social Media – Testimonial Rule

Rule 206(4)-1(a)(1) was designed to address the nature of testimonials when used in investment advisory advertisements. When it adopted the rule, the SEC stated that, in the context of investment advisers, it found "…such advertisements are misleading; by their very nature they emphasize the comments and activities favorable to the investment adviser and ignore those which are unfavorable." The staff has stated that the rule forbids the use of a testimonial by an investment adviser in advertisements "because the testimonial may give rise to a fraudulent or deceptive implication, or mistaken inference, that the experience of the person giving the testimonial is typical of the experience of the adviser's clients."

Social Media – Testimonial Rule

The testimonial rule results in numerous interpretive issues relating to the use of social media by advisers and investment adviser representatives (IARs).

In late 2010, the SEC sent a “sweep” letter to a number of registered investment advisers seeking data on the use of social media.

The SEC’s Division of Investment Management provided guidance on a number of issues related to the use of social media in IM Guidance Update No. 2014-4, March 2014.

The guidance addresses the use by an adviser or IARs of social media sites for business purposes. The guidance does not address the use by individuals of social media sites for purely personal reasons.

Social Media – Third Party Commentary

An investment adviser or IAR may not publish public commentary that is an explicit or implicit statement of a client's experience with or endorsement of the investment adviser or IAR on the investment adviser's or IAR's social media site.

Generally, the SEC staff believes that such public commentary would be a testimonial within the meaning of rule 206(4)-1(a)(1) and its use in an advertisement by an investment adviser or IAR would therefore be prohibited.

- For example, if an investment adviser or IAR invited clients to post such public commentary directly on the investment adviser's own Internet site, blog or social media site that served as an advertisement for the investment adviser or IAR's advisory services, those testimonials would not be permissible.

Social Media – Third Party Commentary

An investment adviser or IAR may publish the same public commentary on its own internet or social media site if it comes from an independent social media site under certain circumstances.

When an investment adviser or IAR has no ability to affect which public commentary is included or how the public commentary is presented on an independent social media site; where the commentators' ability to include the public commentary is not restricted, and where the independent social media site allows for the viewing of <u>all</u> public commentary and updating of new commentary on a real-time basis, the concerns underlying the testimonial prohibition may not be implicated.

Social Media – Third Party Commentary

Publication of public commentary from an independent social media site would not raise any of the dangers that rule 206(4)-1(a)(1) was designed to prevent if:

- the independent social media site provides content that is independent of the investment adviser or IAR;
- there is no material connection between the independent social media site and the investment adviser or IAR that would call into question the independence of the independent social media site or commentary; and
- the investment adviser or IAR publishes <u>all</u> of the unedited comments appearing on the independent social media cite regarding the investment adviser or IAR.

Social Media – Third Party Commentary

Under these circumstances, an investment adviser or IAR may include such public commentary in an advertisement without implicating the concerns underlying the testimonial rule.

If, however, the investment adviser or IAR drafts or submits commentary that is included on the independent social media site, the testimonial rule generally would be implicated. Also, if the investment adviser or IAR is allowed to suppress the publication of all or a portion of the commentary, edit the commentary or is able to organize or prioritize the order in which the commentary is presented, the testimonial rule generally would be implicated.

Social Media – Third Party Commentary

Commentary would not be independent of an investment adviser or IAR if the investment adviser or IAR directly or indirectly authored the commentary on the independent social media site, whether in their own name, a third party's name, or an alias, assumed or screen name.

An investment adviser or IAR would have a material connection with a site or commentary that would call into question the independence of the site or commentary if, for example, the investment adviser or IAR:

- compensated a social media user for authoring the commentary, including with any product or service of value; or
- prioritized, removed or edited the commentary.

Social Media – Third Party Commentary

- For example, an investment adviser could not have a supervised person submit testimonials about the investment adviser on an independent social media site and use such testimonials in advertisements without implicating the testimonial rule.
- An investment adviser or IAR could not compensate a client or prospective client (including with discounts or offers of free services) to post commentary on an independent social media site and use such testimonials in advertisements without implicating the testimonial rule.

Social Media – Third Party Commentary

An investment adviser or IAR may publish testimonials from an independent social media site in a way that allows social media users to sort the criteria under certain conditions.

An investment adviser's or IAR's publication of testimonials from an independent social media site that directly or indirectly emphasizes commentary favorable to the investment adviser
or IAR or de-emphasizes commentary unfavorable to the investment adviser or IAR would implicate the prohibition on testimonials.

The investment adviser may publish only the totality of the testimonials from an independent social media site and may not highlight or give prominence to a subset of the testimonials.

Social Media – Third Party Commentary

- Investment adviser or IAR sites may publish the testimonials from an independent social media site in a content-neutral manner, such as by chronological or alphabetical order, which presents positive and negative commentary with equal prominence.
- Social media users, however, are free to personally display the commentary and sort by any criteria, including by the lowest or highest rating. Investment adviser and IAR sites may facilitate a user's viewing of the commentary by providing a sorting mechanism as long as the investment adviser or IAR site does not itself sort the commentary.

Social Media – Third Party Commentary

An investment adviser or IAR may publish testimonials from an independent social media site that includes a mathematical average of the public commentary in certain circumstances.

Publication by an investment adviser or IAR of such testimonials from an independent social media site would not raise any of the dangers that Rule 206(4)-1(a) (1) was designed to prevent if the independent social media site were designed to make it equally easy for the public to provide negative or positive commentary about an investment adviser or IAR.

Social Media – Third Party Commentary

- Investment advisers or IARs could publish testimonials from an independent social media site that include a mathematical average of the commentary provided that commenters themselves rate the investment advisers or IARs based on a ratings system that is not designed to elicit any pre-determined results that could benefit any investment adviser or IAR.
- The independent social media site, the investment adviser and the IAR may not provide a subjective analysis of the commentary.

Social Media – Inclusion of Investment Adviser Advertisements on Independent Social Media Sites

An investment adviser or IAR may publish public commentary from an independent site if that site also features the investment adviser or IAR's advertising under certain circumstances.

The existence of an investment adviser or IAR's advertisement within the architecture of an independent site that also contains independent public commentary does not, in combination, create a prohibited testimonial or otherwise make the advertisement false or misleading, provided that the investment adviser complies with the material connection and independence factors described above and provided that the advertisement is easily recognizable to the public as a sponsored statement.

Social Media – Inclusion of Investment Adviser Advertisements on Independent Social Media Sites

- In other words, an advertisement would not cause the investment adviser or IAR's publication of the independent social media site's commentary to violate Rule 206(4)-1 where:
  - it would be readily apparent to a reader that the investment adviser or IAR's advertisement is separate from the public commentary featured on the independent social media site and
  - the receipt or non-receipt of advertising revenue did not in any way influence which public commentary is included or excluded from the independent social media site.

Social Media – Reference to Independent Social Media Site Commentary In Non-Social Media Advertisements

An investment adviser or IAR may refer to public commentary from an independent social media site on non-social media advertisements (e.g., newspaper, radio, television) under certain conditions.

An investment adviser or IAR could reference the fact that public commentary regarding the investment adviser or IAR may be found on an independent social media site, and may include the logo of the independent social media site on its non-social media advertisements, without implicating the testimonial rule.

Social Media – Reference to Independent Social Media Site Commentary in Non-Social Media Advertisements

- For example, an IAR could state in its newspaper ad "see us on [independent social media site]," to signal to clients and prospective clients that they can research public commentary about the investment adviser or IAR on an independent social media site.
- In contrast, an investment adviser or IAR may not publish any testimonials from the independent social media site on the newspaper ad without implicating the testimonial rule.

Social Media – Client Lists

A list or photographs of "friends" "or "contacts" on an investment adviser or IAR's social media site that is viewable by the general public would not be considered a testimonial but could otherwise violate section 206(4) or Rule 206(4)-1 in certain circumstances.

It is common on social media sites to include a communal listing of contacts or friends. The SEC staff has stated that an advertisement that contains a partial client list that does no more than identify certain clients of the adviser cannot be viewed either as a statement of a client's experience with, or endorsement of, the investment adviser, and therefore is not a testimonial. Such an advertisement, however, could be false or misleading under Rule 206(4)-1(a)(5) depending on the facts and circumstances.

Social Media – Client Lists

- If the contacts or friends are not grouped or listed so as to be identified as current or past clients of an IAR, but are simply listed by the social media site as accepted contacts or friends of the IAR in the ordinary course, such a listing of contacts or friends generally would not be considered to be in violation of Rule 206(4)-1(a)(1).
- However, if an IAR attempts to create the inference that the contacts or friends have experienced favorable results from the IAR's investment advisory services, the advertisement could be considered to be in violation of section 206(4) and Rule 206(4)-1.

Social Media – Fan/Community Pages

Individuals unconnected with a particular investment adviser or IAR may establish "community" or "fan" or other third-party sites where the public may comment on a myriad of investment topics, along with commentary regarding an investment adviser firm or individual IARs. Such sites may raise concerns under Rule 206(4)-1.

In the ordinary course, a third party's creation and operation of unconnected community or fan pages generally would not implicate Rule 206(4)-1.

However, the SEC staff strongly cautioned investment advisers and supervised persons when publishing content from or driving user traffic to such sites (including through hyperlinks to such sites), particularly if the site does not meet the material connection and independence conditions described above.

Social Media – Fan/Community Pages

The SEC has stated that:

> *any SEC-registered investment adviser (or investment adviser that is required to be SEC registered) that includes, in its web site or in other electronic communications, a hyperlink to postings on third-party web sites, should carefully consider the applicability of the advertising provisions of the [Advisers Act]. Under the Advisers Act, it is a fraudulent act for an investment adviser to, among other things, refer to testimonials in its advertisements.*

Social Media – Compliance Procedures

Fund managers should include a discussion of the use of social media in their compliance procedures.

The discussion of the use of social media in the compliance procedures should be tailored to the business of the fund manager.

Looking For Broker-Dealer Issues

Section 15(a) of the Securities Exchange Act of 1934 makes it unlawful for a “broker” or “dealer” to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security) unless such broker or dealer is registered with the SEC.

States have similar laws on their books.

“Broker” Defined

- Section 3(a)(4)(A) of the Exchange Act defines the term “broker” as “any person *engaged in the business* of *effecting transactions* in securities for the account of others.” (emphasis added)
- The terms “engaged in the business” and “effecting transactions” are not defined in the Exchange Act.
- Instead, through a series of releases and no-action letters, the SEC and its staff have listed a number of factors they look at in determining whether a market participant is required to register as a B/D.
- Through this process, the SEC staff has created a limited exception from broker-dealer registration for “finders.”

Common Factors

There is no bright-line test. The determination is necessarily based on all of the relevant facts and circumstances. But the most common factors are:

- ***Receiving transaction-related compensation*****;**
- Holding oneself out as a broker;
- Participating in the securities business with some degree of regularity;
- Assisting an issuer to structure prospective securities transactions;
- Helping an issuer to identify potential purchasers;
- ***Soliciting securities transactions (significant investor contact; negotiation)***;
- Participating in the order-taking; and
- Previous securities registration and/or disciplinary actions.

Transaction-Based Compensation

- Any compensation "directly related to the success of the sale of the subject securities."
- It is the <u>single most important hallmark</u> of broker status. The SEC wants to ensure that individuals and entities with a "salesman's stake" in the transaction are regulated.
- From the SEC staff's unspoken view-point– this factor alone is sufficient to require registration.
- There is no comfort in the no-action letters.
  - *Paul Anka (1991)* – the "one and done" rule.
  - *Brumberg, Mackey & Wall* (2010)– if transaction-based compensation is present, SEC staff will most likely find other factors.

Significant Contacts with Investors

Even in the absence of transaction-based compensation, there are certain activities that raise such serious public protection concerns that the SEC would most likely require registration. In particular, the SEC will look at nature of the finder's relationship and contacts with the investor:

- Providing PPMs, other offering documents, and marketing materials to investors.
- Participation in the negotiations between the potential investor and the issuer.
- Making recommendations to potential investors regarding an investment in the issuer, or advising potential investors on the merits of any investment opportunity.
- **Type of investor generally is not relevant.**

True Consultants/Pure Referrals Potentially OK Under Finder Exception

Provided that a finder neither receives transaction-based compensation nor has significant contacts with investors, the no-action letters indicate that an unaffiliated finder may engage in the following activities without registering as a broker:

- refer the names and contact information of potential investors to the issuer;
- assist the issuer in determining the terms of the offering;
- help prepare materials (including private placement memorandums, financial data, sales literature or other offering materials);
- provide market and financial analyses;
- prepare feasibility studies;
- advise issuer on its financial potential and recommend methods of financing; &
- advise on the administrative work involved in an offering.
- **fixed fees or hourly rates that are reasonably related to the services provided, and get paid regardless of the outcome of the deal (true consulting fees).**

Safe Harbor for "Associated Persons of Issuers"

- Rule 3a4-1 of the Exchange Act provides a non-exclusive safe harbor from the broker-dealer registration provisions for an "associated person of an issuer."
- Defined as any natural person who is a partner, officer, director, or employee of
  - (i) the issuer;
  - (ii) a corporate general partner of a limited partnership that is the issuer;
  - (iii) a company or partnership that controls, is controlled by, or is under common control with, the issuer; or
  - (iv) an investment adviser registered under the Advisers Act to an investment company registered under the Investment Company Act of 1940 which is the issuer

Preliminary Conditions

To qualify for the safe harbor, the individual must meet all 3 of the preliminary conditions:

(1) Statutory Disqualification: Not subject to a statutory disqualification;

(2) Compensation: **Does not direct or indirect compensation tied to securities transactions**. Whether this condition is met will depend on all the facts and circumstances. For example, in looking at bonuses, factors considered are: (1) when the offering begins and ends; (2) when the bonus is paid; (3) when issuer determines bonus will be paid; (4) when associated persons are informed of the issuer's determination; and (5) whether the bonus paid varies with the success in selling the issuer's securities.

(3) Broker-Dealer Association: Not, at the time of his participation, an associated person of a broker or dealer.

Meet 1 of 3 Alternative Conditions

(1) Active Solicitation Activities:

- primarily performs (or intends to) at the end of the offering, **substantial duties for or on behalf of the issuer** besides offerings. Will be measured in terms of volume and percentage of work performed apart from securities transactions.
- (ii) not a broker or dealer, or an associated person, in last 12 months.
- (iii) only participates in an offering **once every 12 months** other than in reliance on another alternative (except certain shelf offerings.

(2) Certain Types of Investors – Limited in the rule. Does not depend on accredited, qualified purchaser or qualified client status.

(3) Passive Solicitation Activities:

- Preparing and deliver **written communications** to potential investors (no oral solicitation);
- **Responding to inquiries of a potential purchaser** if he/she initiated (response limited to information in offering document); and
- Performing **ministerial and clerical work** involved in effecting any transaction.

Blass Speech – Safe Harbor Not a Silver Bullet

In April 2013, the then Chief Counsel of the Division of Trading and Markets spoke specifically on broker-dealer concerns in the private fund space. Blass outlined some questions fund managers should be asking, particularly with respect to their employees and those of affiliates:

- How do you solicit and retain investors?
- What are the duties and responsibilities of personnel performing such solicitation or marketing efforts? A dedicated sales force of employees working within a “marketing” department may strongly indicates that they are in the business of effecting transactions in the private fund, regardless of how the personnel are compensated.
- Do employees who solicit investors have other responsibilities? If so, consider what those responsibilities are (*i.e.*, are the primary functions of these employees to solicit investors).
- How are personnel who solicit investors for a private fund compensated? Do those individuals receive bonuses or other types of compensation that is linked to successful investments?
- Do you charge a transaction fee in connection with a securities transaction?

Blass Speech (cont.) – Focus on Fees

Blass also cautioned managers to consider fees they charge and in what way, if any, they are linked to a security transaction.

- Example: Fees the manager directs a portfolio company of the fund to pay directly or indirectly to the adviser or one of its affiliates in connection with the acquisition or disposition (including an initial public offering) of a portfolio company or a recapitalization of the portfolio company. Fees described as compensation for manager, affiliates or personnel for “investment banking activity,” including negotiating transactions, identifying and soliciting purchasers or sellers of the securities of the company, or structuring transactions.
- The general partner will NOT be be viewed as the same person as the fund -- transactions will be for the *account of others*.
- To the extent the advisory fee is wholly reduced or offset by the amount of the transaction fee, should be OK.

So What? Consequences of Not Registering

Finder" "Consultant" "Partner" – primary liability under Section 15(b) of the Exchange Act

- cease-and-desist orders from the SEC or relevant state regulator or court injunctions;
- civil penalties including fines and disgorgement;
- criminal liabilities;
- potential rescission rights of investors under federal or state law; and
- reputational harm.

Issuer/Fund Manager - secondary liability under Section 20 of the Exchange Act for aiding and abetting.

Ram Capital Case – Signal of Change

- Administrative proceedings against Ram and two individuals, Fein and Saltzstein, in June 2009.
- Well-known in the PIPEs market– offerings often brought to them.
- Identified and solicited investors for PIPEs from 2001-2005
- Also advised on structure of offerings (incl. drafting initial term sheet, securities purchase agreement) and negotiated with investors and issuers.
- Majority of investors were hedge funds
- Typical Compensation: 3.5% of gross amount invested by each solicited investor, and 25% of all warrants allocated to the investors.

Ram (cont.)

- **<u>SEC</u>: "knew or were <u>reckless in not knowing</u> that Ram's compensation structure for its services required Ram to register as a broker-dealer. In fact, others in the industry questioned Fein about whether Ram should be registered based on the services Ram was providing and how it was compensated for such services."**
- <u>Penalties</u>**:** (1) cease and desist order; (2) suspended from association with any broker-dealer for 6-12 months; and (3) disgorgement, prejudgment interest and civil penalties ($60-90k). (approx. total - $500k each)

Ranieri Partners – SEC Unrelenting In Its Position

- In March 2013, SEC brought companion cases against a consultant who acted as an unregistered broker for a private equity fund, and against the fund manager and one of its principals for aiding and abetting.

In the Matter of William M. Stephens – The Unregistered Broker

The SEC alleged that, while working as an independent consultant, Stephens actively solicited investors on behalf of private funds managed by Ranieri Partners' affiliates and, in return, received transaction-based compensation totaling approximately $2.4 million. While typically the SEC staff focuses on the compensation, this case centered around Stephens' solicitation efforts:

- sending private placement memoranda, subscription documents, and due diligence materials to potential investors;
- urging at least one investor to consider adjusting its portfolio allocations to accommodate an investment with Ranieri Partners;
- providing potential investors with his analysis of Ranieri Partners' funds' strategy and performance track record; and
- Providing potential investors with confidential information relating to the identity of other investors and their capital commitments.

By these actions, engaged in effecting securities transactions. Sanctions incl. disgorgement and prejudgment interest of $410k and barred from the securities industry.

In the Matter of Ranieri Partners LLC and Donald W. Phillips -- Aiding and Abetting

- SEC alleged that Ranieri Partners and its then Senior Managing Partner, Donald Phillips, provided Stephens with key documents and information related to Ranieri Partners' private equity funds and did not take adequate steps to prevent Stephens from having s<u>ubstantive contacts </u>with potential investors.
- According to Phillips, he informed Stephens that Stephens' activities on behalf of Ranieri Partners were limited to contacting potential investors to arrange meetings for the principals of and that he specifically informed Stephens that he was not permitted to provide PPMs directly to potential investors.
- Phillips also argued that he informed Stephens that Stephens was not permitted to contact investors directly to discuss his views of the merits and strategies of the funds.

How Are the Regulators Going to Know?

- **SEC Examination of Fund Mangers–** SEC is looking at every dollar going into and out of the fund, fund manager, portfolio companies, affiliates, etc.
- **Form D**: Item 12 on Form D requires the issuer to identify the name, address and registration number (if applicable) of any person that "*has been or will be paid directly or indirectly any commission or similar compensation in cash or other consideration in connection with sales of securities in the offering, including finders*."
  - An amendment to Form D: required if 10% increase in the amount of sales commissions, finders' fees or use of proceeds for payments
  - Failure to disclose will most likely be considered a material non-disclosure, subjecting issuers to a potential fraud claim
  - More than a 1/3 of the states are routinely reviewing these forms to try and catch unregistered brokers.
- **Litigation:** Civil litigation between parties
- **FINRA**: FINRA application requires a statement confirming that "the applicant has not previously conducted a securities business, is not currently engaged in the conduct of a securities business, and will refrain from conducing a securities business until it has received approval from FINRA." (similar to many state requirements)
- **Whistleblower:** Disgruntled investor/competitor/employee.

CCO Liability - Ceresney Speech – May 20, 2014

SEC Director of Enforcement Andrew Ceresney delivered the keynote address at Compliance Week 2014.

Ceresney's speech contained a detailed discussion of the SEC's position on the duties of compliance personnel, as well as the types of situations where the SEC will seek to penalize compliance officers.

CCO Liability - Ceresney Speech – May 20, 2014

Ceresney noted that, at that point, the SEC had brought 10 actions as part of the Compliance Program Initiative, including charges against compliance personnel when they were clearly responsible for the failure to adopt or implement adequate compliance programs. Consistent with those cases, Ceresney emphasized that the SEC will take action against compliance officers if:

- they actively participated in misconduct,
- they helped mislead regulators, or
- they have clear responsibility to implement compliance programs or policies and wholly failed to carry out that responsibility.

Ceresney pointed to the Penson case discussed below as implicating all of these areas. The Meade case, also discussed below, is a more recent example of this type of situation.

CCO Liability – Penson

On May 19, the SEC filed an administrative proceeding against Thomas Delaney II and Charles Yancey for violations related to Rule 204T/204 of Regulation SHO. Delaney is the former chief compliance officer (CCO) and Yancey is the former president/chief executive officer (CEO) of Penson Financial Services, Inc., which, before declaring bankruptcy in January 2013, was one of the largest independent clearing firms in the U.S. Delaney and Yancey are contesting the charges.

Rule 204T/204 requires participants of a registered clearing agency to deliver equity securities to a registered clearing agency by a settlement date. If the participant does not deliver the shares to the clearing agency in a timely manner, referred to as failure to deliver, it must take affirmative action to close out the failure-to-deliver position by purchasing or borrowing securities within a specified period.

CCO Liability – Penson

According to the SEC, when Penson's customers caused a failure to deliver, the buy-ins department purchased or borrowed shares to fulfill its close-out obligations and passed along the costs of those transactions to its customers. In contrast, on thousands of occasions between October 2008 and November 2011, Penson caused failures to deliver by lending securities from customers' margin accounts, which securities the customers subsequently sold. In those instances, unable to pass along the cost of compliance to customers, senior officers in the stock loan department ignored the requirements of Rule 204T/204 and failed to deliver the subject securities.

CCO Liability – Penson – CCO Issues

According to the SEC, Delaney aided and abetted and caused Penson's violations of Rule 240T(a)/204(a). The SEC alleges that Delaney knew the stock loan department was not complying with Rule 204T and had intentionally noncompliant Rule 204(a) procedures, yet did not take any action to change the procedures or report them to senior management.

Delaney also is accused of establishing and maintaining a supervisory system that he knew allowed others to effectively remain unsupervised, and concealing the violations from Penson's CEO and from regulators.

CCO Liability – Penson – CCO Issues

Among other things, the SEC alleges that:

- An internal compliance audit showed a 99 percent fail rate on close-out procedures, which are directly related to the procedures for long sales of loaned securities.
- Delaney agreed with other Penson employees that Penson would not comply with the applicable Regulation SHO requirements in large part because of the expected costs.
- Penson's written compliance procedures failed to contain compliant provisions and did not describe the procedures actually being used. Despite knowing about the violations for nearly two and a half years, Delaney took no steps to ensure that the procedures were changed to comply with the rules and in fact adopted written procedures that were designed to conceal the firm's actual procedures.

CCO Liability – Penson – CCO Issues

- Delaney permitted and/or caused the firm to mislead the SEC concerning these issues.
- Delaney failed to bring these issues to the firm's CEO.

CCO Liability – Penson – CEO Issues

Penson's CEO, Yancey, is charged with failing to reasonably supervise both Delaney and Penson's senior vice president of stock loan, who directly oversaw the firm's securities lending business. Penson's written supervisory procedures designated Yancey as the direct supervisor of both the senior vice president of stock loan and Delaney. According to the SEC, Yancey expressed to Delaney that he did not trust the senior vice president of stock loan, and complained of insufficient control over him. However, Yancey took no steps to fix things. The SEC also alleges that Yancey deliberately ignored "significant red flags" contained in a 2009 audit by Penson, which should have informed him that the firm's CCO bore responsibility for Rule 204 deficiencies.

CCO Liability – Related Penson Actions

Additionally, the SEC instituted settled administrative proceedings against Lindsey Wetzig and Michael Johnson, former employees of the securities lending department of Penson's parent company, Penson Worldwide, Inc. According to the SEC, Wetzig caused Penson's violations of Rules 204T(a) and 204(a), and Johnson aided and abetted Penson's violations of Rules 204(a) and 204(b), and failed to supervise two vice presidents in the securities lending department. Without admitting or denying the SEC's findings, Wetzig and Johnson agreed to cease and desist from future violations. Wetzig agreed to cooperate with the SEC, and Johnson agreed to be barred for five years and to pay a civil penalty of $125,000.

CCO Liability – Significance of the Penson Case

In his May 20, 2014, speech, Ceresney indicated that the SEC would take action against CCOs where they actively participate in misconduct or wholly fail to carry out their responsibilities. Ceresney pointed to the Penson case as illustrating these situations and stated:

> [T]he Division alleged that the firm violated Reg SHO for more than three years and that the CCO not only knew about the firm's decision to violate the rules, but also affirmatively participated in the violations by, among other things, failing to implement procedures that he was responsible for implementing and that would have brought the firm into compliance, and then concealing those violations from regulators.

CCO Liability – Significance of the Penson Case

Here, if the facts alleged against Penson's CCO are proven, the SEC would show that the firm's CCO

- knowingly permitted a regular business practice that was in violation of applicable law,
- wrote compliance procedures that concealed the actual noncompliant procedures and
- misled regulators about the issue.

The SEC's allegations as to Penson's CEO raise the question of when is there sufficient evidence of a problem to require action on the part of a supervisor. The allegations also appear to raise the issue of whether supervisory liability is present if others in the entity actively try to hide the problem from the supervisor. In this case, the alleged facts would demonstrate that the CEO failed to supervise the firm's CCO, ignored the CCO's concealment of violations from regulators, and wholly failed to supervise the firm's senior vice president, who oversaw and directly engaged in the conduct giving rise to the rule violations, despite the CEO being designated as his direct supervisor.

CCO Liability – Meade

On June 11, 2014, the SEC instituted a settled administrative proceeding against Thomas E. Meade, former CEO and COO of Private Capital Management Inc. (PCM), in connection with his role in PCM's failure to prevent, detect or respond to insider trading by a former PCM vice president, Drew Peterson, in 2010.

PCM, with a staff of four to five people, provided investment advisory services focused on no-load mutual funds to more than 300 accounts and managed more than $150 million in assets. PCM ceased advisory operations on July 31, 2012, and filed its Form ADV-W with the SEC on January 22, 2013, terminating its registration as an investment adviser.

CCO Liability – Meade

In April 2010, Peterson received a tip from his father regarding the pending acquisition of a public company. At the time, Peterson's father served on the board of directors of the public company and as the chairman of its audit committee. On the basis of that information, Peterson traded securities of the public company for his own account, his family members, his investment club and investment clients, and passed the inside information on to certain friends, including a hedge fund manager.

In August 2011, the SEC filed a civil complaint alleging Peterson and his father engaged in insider trading. In the following months, the SEC amended the complaint to include the hedge fund manager, which then was followed by a criminal complaint against all three defendants. All three defendants pled guilty in the criminal action and settled the SEC action.

CCO Liability – Meade

In August 2010, OCIE conducted a cause examination of PCM out of concern that Peterson's trading and dissemination of material, nonpublic information had gone undetected. The findings of that exam resulted in a referral to the SEC's Division of Enforcement, which in turn led to Meade's settlement with the SEC.

The SEC's administrative order found that Meade, the president and CCO of PCM during the relevant period, was aware of the unique risks for misuse of material, nonpublic information by Peterson due to Meade's personal relationship with Peterson's father, but that Meade failed to design PCM's written compliance policies and procedures in light of these insider trading risks associated with PCM's particular operations.

CCO Liability – Meade

The SEC also found that Meade failed to adequately collect and review records of personal trading by PCM employees during the relevant period and failed to maintain restricted or watch lists of stocks in each case as required under the firm's policies and procedures. Further, even after learning of Peterson's insider trading, Meade failed to conduct any investigation of the trading as required by the firm's policies and procedures and failed to document violations of the firm's code of ethics.

Finally, the SEC found that, as CCO, Meade was responsible for administering PCM's policies and procedures, yet he relied too much on employees to self-report violations and failed to annually assess the adequacy or effectiveness of PCM's policies and procedures that were in place.

CCO Liability – Violations and Penalties in Meade

As a result of the conduct described above, the SEC found that PCM willfully violated, and Meade willfully aided and abetted and caused PCM's violations of:

- Section 204A of the Advisers Act and Rule 204A-1 thereunder, which require that a registered investment adviser establish, maintain and enforce a written code of ethics;
- Section 204(a) of the Advisers Act and Rules 204-2(a)(12-13) thereunder, which require that investment advisers registered with the SEC maintain and preserve certain books and records; and
- Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which, among other things, require that a registered investment adviser adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules.

CCO Liability – Violations and Penalties in Meade

The SEC’s order further found that Meade failed to reasonably supervise Peterson within the meaning of Section 203(e)(6) of the Advisers Act, with a view to preventing violations of the Advisers Act and rules thereunder.

Without admitting or denying the findings, Meade was censured and agreed to cease and desist from future violations, pay a $100,000 civil penalty and be effectively barred from the securities industry. Specifically, Meade was:

- barred from associating in a compliance capacity and supervisory capacity with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent or nationally recognized statistical rating organization; and
- prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter.

CCO Liability – Significance of the Meade Case

The SEC found that Meade did not adequately carry out his duties as a CCO and president by:

- failing to maintain and enforce a written code of ethics,
- failing to maintain required books and records, and
- failing to adopt and implement compliance policies and procedures tailored to address the specific risks inherent in his firm's operations.

As in *Penson*, there is also a supervision component, in that according to the SEC, Meade did not adequately supervise Peterson.

CCO Liability – Significance of the Meade Case

Section 203(e)(6) of the Advisers Act provides a safe harbor for failure-to-supervise claims where there are procedures in place that would be expected to prevent and detect violations and the supervisor discharges his duties and obligations without reasonable cause to believe that these procedures are not being followed. The SEC found that this safe harbor was not available because the compliance failures were so pervasive that Meade, as CCO, could not have had reasonable cause to believe that PCM was in a position to prevent and detect the insider trading that occurred.

CCO Liability – Takeaways

The Ceresney speech provides a framework for analyzing the types of situations that could result in SEC enforcement actions against compliance personnel.

The speech, together with the SEC's allegations and actions in the *Penson* and *Meade* proceedings, indicate the importance for compliance personnel to be proactive in their approach to fulfilling their obligations and duties as compliance officers.

CCO Liability – Takeaways

In summary, CCOs and other compliance personnel should consider the following takeaways from the speech and enforcement actions:

- CCOs need to be proactive in carrying out their duties and responsibilities under applicable securities laws and regulations.
- CCOs need to be proactive in carrying out the functions assigned to them in their firm’s compliance policies and procedures.
- CCOs who have knowledge of possible or actual securities law violations at their firms must be proactive in investigating and reporting the potential or actual violations to members of their firms' senior management.

CCO Liability – Takeaways

These cases also underscore the continuing risk of claims by the SEC of inadequate supervision. In the *Penson* case, the CEO is alleged to have failed to supervise both the CCO and a senior employee who caused the securities law violations and to have ignored "red flags" concerning those violations. In Meade, the CEO and CCO allegedly did not supervise a corporate officer who engaged in insider trading, and ignored red flags concerning a vice president's access to material, nonpublic information. These cases provide stark reminders that supervisory personnel must:

- take seriously their supervisory roles and proactively carry out the duties outlined in their firms' compliance policies and procedures; and
- proactively follow up on red flags that may indicate underlying securities issues.

Questions or Comments?

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