Ropes & Gray's Private Investment Fund Update: November 2012

Highlights

- SEC Publishes Letter to Private Fund Industry Regarding Presence Exams (pg. 3). On October 9, 2012, the SEC published a letter to newly registered investment advisers identifying topical areas that may be featured during examinations.

- New FINRA Rule 5123 on Private Placement of Securities (pg. 5). The SEC recently approved new FINRA Rule 5123 requiring notice filings with respect to private placement sales. Effective as of December 3, 2012, FINRA member firms will be required to make this filing with FINRA unless they fall within an exemption.

- Investment Adviser User Fee Legislation Introduced in Congress (pg. 5). A bill recently introduced to Congress proposes to have certain investment advisers pay fees to help cover the costs of inspecting and examining investment advisers under the Advisers Act, though no fee amounts are specified.

- SEC Announces First Pay-to-Play Case Involving In-Kind Political Contributions (pg. 6). The SEC announced a pay-to-play case against Goldman, Sachs & Co. and an executive arising from non-cash political contributions.

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- Industry Groups React to Proposed Rules to Remove Prohibitions on General Solicitation and General Advertising in Certain Regulation D Offerings (pg. 4). After the SEC proposed an amendment to Rule 506 (providing private funds with more flexibility in marketing their fund interests), several industry and consumer groups raised questions.

- New FINRA Rule 5123 on Private Placement of Securities (pg. 5). The SEC recently approved new FINRA Rule 5123 requiring notice filings with respect to private placement sales. Effective as of December 3, 2012, FINRA member firms will be required to make this filing unless they fall within an exemption.

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Regulatory Developments

SEC Publishes Letter to Private Fund Industry Regarding Presence Exams

On October 9, 2012, the United States Securities and Exchange Commission (the "SEC") published a letter to newly registered investment advisers to introduce the National Exam Program (the "NEP") and provide certain information about upcoming examinations and the topical areas that may be examined. Over the next two years, the NEP will begin conducting focus, risk-based examinations with respect to newly registered investment advisers of private funds (the "Presence Exams"). These Presence Exams have three primary phases: engagement; examination; and reporting:

- *Engagement Phase*. During the engagement phrase, the NEP will engage in a nationwide outreach program to inform newly registered investment advisers about (among other things) their obligation under the Investment Advisers Act of 1940 (the "Advisers Act") and the Presence Exams. In anticipation of the engagement phase, the NEP and the SEC has published various compliance materials, staff letters, staff issued no-action letters, interpretive guidance risk alerts, and other documents available on the SEC's website. A link to the speech given by Director Carlo di Florio earlier this year, discussing examinations of private equity firms in more detail, is available here.

- *Examination Phase*. During the examination phase, the NEP will review one or more of the following areas that the NEP deems to be "higher-risk" with respect to the firm:

  - Marketing: The NEP staff may review marketing materials and evaluate whether all materials are in compliance with the Advisers Act and are not false or misleading.

  - Portfolio Management: The NEP staff may review a firm's portfolio decision-making practices and allocation of investment opportunities, and evaluate whether such practices are consistent with the disclosure provided to investors.

  - Conflicts of Interest: The NEP staff may review the procedures, policies and controls used to identify, mitigate and resolve certain conflicts of interests (including conflicts relating to allocation of investments, fees, and transactions with affiliated parties).

  - Safety of Client Asset: The NEP may review the policies and procedures to protect client assets from loss or theft, and evaluate whether such policies are in compliance with the Advisers Act.

  - Valuation: The NEP staff may review the valuation policies and procedures, including methodology for valuing illiquid or difficult to value investments, and the methods for calculating management and performance fees.

- *Reporting Phase*. Following the completion of the examination phase, the NEP intends to report its observations and conclusions to the SEC and the public. Such observations may include common practices, industry trends and significant issues.

The NEP staff will contact an investment adviser separately if it is selected for an examination. Please consider whether your firm would be prepared for an exam if you received a notice from the NEP staff.

Industry Groups React to Proposed Rules to Remove Prohibitions on General Solicitation and General Advertising in Certain Regulation D Offerings

The Jumpstart Our Business Startups Act, enacted earlier in 2012 (the "JOBS Act"), directed the SEC to amend Rule 506 of Regulation D ("Rule 506") of the Securities Act of 1933, as amended (the "Securities Act"), to allow issuers to engage in "general solicitation" and "general advertising" in offerings made under Rule 506, so long as all purchasers of the securities in such offerings are accredited investors.

On August 29, 2012, the SEC proposed an amendment to Rule 506 to implement these provisions of the JOBS Act. If adopted as proposed, the amendment will provide certain private equity funds, hedge funds and other private funds with substantially more flexibility in marketing fund interests. More information on the proposed amendment is available here.

However, significant questions remain and several industry and consumer groups submitted comments to the proposed amendment on various issues, including:

- ***Verification***. The proposed rule includes the steps fund sponsors may be required to take under new Rule 506(c) to verify that investors are "accredited investors." While proposed Rule 506(c) does not contain any required methods or establish any safe harbor for issuers to follow in verifying the accredited investor status of purchasers, the SEC's guidance from the proposed rule release indicates that it "[does] not believe that an issuer would have taken reasonable steps to verify accredited investor status if it required only that a person check a box in a questionnaire or sign a form, absent other information about the purchaser indicating accredited investor status," where the issuer had solicited investors through a website, a widely disseminated e-mail or social media. Industry groups have commented that the SEC should not impose a higher burden than the "reasonable belief" standard currently contained in Rule 506 and that certification should constitute reasonable steps for purposes of the rule. Consumer groups, on the other hand, urged the SEC to raise the accredited investor standard and to require production of evidence to demonstrate the required level of income level or net worth.

- ***Regulation S***. The SEC's proposing release sought to address whether an issuer could use general solicitation or general advertising in reliance on proposed Rule 506(c) while simultaneously offering securities under Regulation S. Several of the comments submitted requested that the SEC consider amending the second safe harbor requirement under Regulation S ("no directed selling efforts in the U.S.") to clarify that general solicitation and general advertising permissible under proposed Rule 506(c) would not preclude an issuer from also relying on the safe harbor in Regulation S in connection with a simultaneous non-US offering. Instead, the SEC merely reiterated prior guidance (provided by the SEC staff under a regime where "general solicitation" and "direct selling efforts" were often viewed as functional equivalents) that so long as foreign offerings and sales are made in compliance with Regulation S, such offerings and sales will not be integrated for the purpose of Regulation S with domestic offerings and sales made under proposed Rule 506(c).

- ***Exemptions***. Section 201(b) of the JOBS Act provides that "[o]ffers and sales exempt under [Rule 506] (as revised pursuant to [the JOBS Act]) shall not be deemed public offerings under the Federal securities laws as a result of general advertising or general solicitation." The SEC stated in the proposing release that it interprets Section 201(b) of the JOBS Act to permit private funds to use general solicitation and general advertising in connection with the offer and sale of securities under proposed Rule 506(c) and that such offer and sale would still qualify as a non-public offering for the purposes of Sections 3(c)(1) and 3(c)(7) under the Investment Company Act of 1940 (the "Investment Company Act"). Commenters have requested the SEC confirm this point in the final rule.

The proposed amendment is available here, and the comment period closed on October 5, 2012. **Fund sponsors should note that Rule 506(c) was issued as a proposed rule, and not an interim final temporary rule. As a result, existing restrictions on general solicitation and general advertising continue to apply to private fund offerings in the US, pending adoption of the final rule.**

New FINRA Rule 5123 on Private Placement of Securities

The SEC recently approved new FINRA Rule 5123 requiring a notice filing relating to selling securities through private placements. Pursuant to Rule 5123, any FINRA member firm that sells an issuer's securities through a private placement (typically, most placement agents) will be required to file electronically a copy of the private placement memorandum, term sheet, or other offering document with FINRA within 15 calendar days of the date of any sale, unless it falls within an exemption. There is no requirement, however, to report the *amount* of securities sold through such private placement. All such filings will be confidential.

Certain private placements are exempt from this notice filing requirement and many investment advisers will be able to take advantage of these exemptions. An exemption exists in Rule 5123(b)(1) for offerings made solely to institutional accounts, qualified purchasers, qualified institutional buyers (and entities comprised exclusively of qualified institutional buyers), employees and affiliates of the issuer, and certain accredited investors.[1] This exemption allows most private placements of 3(c)(7) funds to avoid the new reporting regime. However, investment advisers who use placement agents for private placements of 3(c)(1) funds can expect that their placement agents will likely be required to file a copy of the private placement memorandum with FINRA.

Rule 5123 will be effective as of December 3, 2012 and will apply prospectively to private placement sales on or after that date. **While all filings will be kept confidential, private fund advisers that work with placement agents should nevertheless be aware of the new FINRA requirements.**

Investment Adviser User Fee Legislation Introduced in Congress

On July 25, Rep. Maxine Waters (D-Calif.) introduced the Investment Adviser Examination Improvement Act of 2012 (the "Bill"). The Bill proposes to amend the Advisers Act to require certain investment advisers to pay fees to help cover the costs of inspecting and examining investment advisers under the Advisers Act. The Bill would authorize the SEC to assess "user fees" on investment advisers.

The SEC Staff, in a previously issued report titled "Study on Enhancing Investment Adviser Examinations," analyzed various ways to enhance investment adviser oversight and recommended that Congress consider three options to strengthen the SEC's investment adviser examination program: (1) authorize the SEC to impose user fees on SEC-registered investment advisers to fund their examinations by the Office of Compliance Inspections and Examinations ("OCIE"); (2) authorize one or more self-regulatory organizations to examine, subject to SEC oversight, all SEC-registered investment advisers; or (3) authorize FINRA to examine dual registrants for compliance with the Advisers Act.

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[1] Pursuant to Rule 5123(b)(1)(J), offerings made to accredited investors described in Securities Act Rule 501(a)(1), (2), (3) or (7) are exempt. This does not include accredited investors that are individuals or entities whose equity owners are all accredited investors.

The Bill would accomplish the SEC's goal through the first method noted above—the assessment of a user fee that would permit the SEC to provide robust oversight of investment advisers. The Bill provides that the fee calculation formula for each fiscal year will be established by rulemaking. If the Bill were passed, the SEC would be directed to establish a formula for determining the fee amount for each fiscal year that takes into account (i) the anticipated costs of conducting inspections and examinations of investment advisers, including the anticipated frequency of such inspections and examinations, (ii) the investment adviser's size, including assets under management (but excluding any assets under management attributed to any clients that are registered investment companies), (iii) the number and type of the investment manager's clients, and (iv) other objective factors, such as risk characteristics, that the SEC deems appropriate. The SEC would make public the formula used to assess fees for each fiscal year. Before the end of each fiscal year, the SEC would review its fee calculation formula, allow for a period of public comment, and then revise such formula, if necessary, before it assesses fees for the next fiscal year.

While there is no action to take at this time, we will alert you to further developments, as the Bill could impose a significant user fee on investment advisers registered with the SEC.

Examination and Enforcement Action Developments

SEC Announces First Pay-to-Play Case Involving In-Kind Contributions

On September 27, 2012, the SEC announced a pay-to-play case against Goldman, Sachs & Co. ("Goldman") and Neil Morrison, a former vice president in Goldman's Boston office, arising from non-cash political contributions. The charges relate to support Morrison gave then-Massachusetts state treasurer Timothy Cahill during his candidacy for Massachusetts governor. Morrison worked on Cahill's political campaigns from 2008 until 2010, using his Goldman office and resources (including the firm's phones and email) to conduct campaign activity. The SEC alleged that such activities disqualified Goldman from 30 underwritings of certain Massachusetts municipal issuers in the following two years under Municipal Securities Reporting Board ("MSRB") Rule G-37. While no Advisers Act rule was implicated in this case, the relevant MSRB rule prohibits providing certain services to a government entity after any relevant employee makes, solicits, or coordinates a contribution to an official of such government entity, a prohibition similar to that found in the pay-to-play scheme of Rule 206(4)-5 under the Advisers Act.

Goldman agreed to settle the case by paying $7.5 million in disgorgement (covering the fees from all of the underwritings referenced above), plus interest and a $3.75 million penalty, the largest ever imposed by the SEC for Municipal Securities Rulemaking Board pay-to-play violations. **Given the SEC's recent focus on the topic, private fund advisers should ensure they have robust compliance programs surrounding pay-to-play rules that address non-cash contributions.**

OCIE Focusing Risk Analytics on Branch Offices

According to a speech given by Director Carlo di Florio earlier this summer, OCIE is shifting the focus of its risk analytics to branch offices of registrants, including registered investment advisers. Director di Florio spoke at an enforcement panel at the Insured Retirement Institute's 2012 Government, Legal and Regulatory Conference in Washington, D.C., and said that branch offices that generate a disproportionate number of complaints, or that appear to have more problems than other branches, will draw increased regulatory scrutiny. At the panel, Director di Florio also said that focus areas for SEC examiners are:

- fraud, including microcap fraud and problematic disclosure practices;

- the “retailization” of complex products, such as principal protected notes, or complex products wrongly marketed to the elderly as safe;
- conflicts of interest;
- valuation and pricing; and
- risk management, supervision, and compliance practices.

Second Circuit Makes it Easier for SEC to Prove Aiding and Abetting Claims

In *Securities and Exchange Commission v. Apuzzo*, the US Court of Appeals for the Second Circuit clarified the elements the SEC must prove in order to succeed in a civil enforcement proceeding based on “aiding and abetting” a violation of securities laws. The defendant Joseph Apuzzo was the Chief Financial Officer of the Terex Corporation (“Terex”), a construction and mining equipment manufacturer. Terex allegedly engaged in certain sale and leaseback transactions with United Rentals, Inc. (“URI”), a large equipment rental company. The SEC alleged that Apuzzo aided and abetted the violations by URI of the federal securities laws by assisting URI in carrying out “sale-leaseback” transactions designed to allow URI to recognize revenue prematurely and to inflate the profit generated from URI’s sales.

The issue before the Second Circuit was whether the district court had incorrectly held, in the context of an SEC civil enforcement case, that “substantial assistance” (an element of an aiding and abetting claim) could only be established by a showing that the aider and abettor was the “proximate cause” of the harm on which the primary violation was predicated. Prior to this decision, some district courts in the Second Circuit had been applying the proximate cause standard to both private suits and government enforcement cases. Conceding that “our case law has not always made this distinction with clarity,” the Second Circuit held that the appropriate standard for determining whether an alleged aider and abettor has provided “substantial assistance” in an SEC civil enforcement action is the standard articulated by Judge Learned Hand in *United States v. Peoni*, in 1938. Under this standard, the SEC must prove that the defendant “in some sort associate[d] himself with the venture, that [the defendant] participate[d] in it as in something that he wishe[d] to bring about, [and] that he [sought] by his action to make it succeed.” By affirming this standard, *Apuzzo* makes it easier for the SEC to prove aiding and abetting claims in the Second Circuit, since it will not be required to prove causation. In addition, the Dodd-Frank Act recently amended the section of the Exchange Act imposing liability on aiders and abettors so that it now includes “reckless” as well as “knowing” conduct. The full opinion is available here.

Tax Related Developments

IRS Releases Draft Investor FATCA Certification Form

On August 13, 2012, the Internal Revenue Service (the “IRS”) released a new draft certification form for compliance with the Foreign Account Tax Compliance Act (“FATCA”). FATCA, which was added to the Internal Revenue Code by the Hiring Incentives to Restore Employment Act of 2010, established an information reporting regime to identify US persons holding assets through offshore entities and overseas accounts.

The new draft Form W-8IMY, Certificate of Foreign Intermediary, Foreign Flow-Through Entity, or Certain US Branches for United States Tax Withholding, available here, is intended to replace the existing Form W-

8IMY, which is currently used to confirm that an entity is an intermediary or flow-through for US tax purposes and to establish that such entity is not a US person. The new form differs from the previous form in that it will now also be used to certify as to FATCA compliance. While Parts II through VI of the form will continue to be used to certify status as a qualified or nonqualified intermediary, a US branch, or as a withholding or nonwithholding foreign partnership or trust, Part I and Parts VII through XXIII are significantly expanded and will be used by an entity to certify as to its FATCA compliance.

Draft instructions for the new Form W-8IMY have not yet been released.

US and UK Sign FATCA Intergovernmental Agreement

On September 14, 2012, the United States Department of the Treasury announced that it had signed a bilateral agreement with the United Kingdom to implement FATCA (the "FATCA Intergovernmental Agreement"). This FATCA Intergovernmental Agreement is the first of its kind and is based largely on a model released by the Treasury Department which was developed in consultation with France, Germany, Italy, Spain, and the United Kingdom. Treasury Assistant Secretary for Tax Policy Mark Mazur noted that this "announcement marks a significant step forward in our efforts to work collaboratively to combat offshore tax evasion."

The FATCA Intergovernmental Agreement acknowledges the substantial compliance burdens FATCA places on funds and their investors, particularly for UK financial institutions that may not be able to comply with certain aspects of FATCA due to domestic legal impediments, and expresses the parties' desire to conclude an agreement to improve international tax compliance and provide for the implementation of FATCA based on domestic reporting and reciprocal automatic exchange, subject to certain confidentiality and other protections.

The FATCA Intergovernmental Agreement includes an annex that lists all of the UK institutions and accounts that will be exempt from FATCA reporting. Specifically, such non-reporting institutions and products include exempt beneficial owners, deemed compliant financial institutions, and exempt products.

Previously Issued Alerts

Below please find more detailed Alerts Ropes & Gray has issued over the past months:

New SEC Enforcement Action Highlights the Unique Role Advisors Play in China-based Reverse Takeover Companies and Due Diligence Problems They Can Create for PE Investors
August 3, 2012

FAQs Regarding Private Equity Firms Launching Registered Funds
August 20, 2012

Changes to Commodity Laws: What Private Equity Firms Need to Know
September 5, 2012

The SEC Proposes Rules to Remove Prohibitions on General Solicitations and General Advertising in Certain Regulation D Offerings
September 7, 2012

[CFTC Provides Temporary Relief Regarding Registration Deadlines for Certain CPOs and CTAs and the Treatment of Foreign Exchange Swaps and Deliverable Forwards]
October 17, 2012

[A Collective Sigh of Relief: IRS Announces Revisions to Timelines for Due Diligence and Other Requirements under FATCA]
October 25, 2012