Ropes & Gray Private Investment Fund Update: July 2014

Highlights

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- *European Commission Decision Implicated the Parental Liability of Private Equity Funds* (pg. 16). Earlier this month, the European Commission penalized a group of high voltage power cable producers for operating as an illegal cartel and additionally penalized the Goldman Sachs Group, Inc. under a theory of derivative parental liability because one of Goldman's private equity funds owned one of the cable producers.
- *SEC Initiative Announced to Target Registered Investment Advisers Who Have Never Undergone Review* (pg. 5). The SEC recently noted its 2014 plan to prioritize the reviews of registered investment advisers that have never undergone a formal compliance examination, particularly those investment advisers located in the U.S. that have been registered for more than three years.
- *SEC Issues New Guidance to Clarify the Term "Beneficial Owner" in Bad Actor Rules* (pg. 6). The SEC recently issued new guidance clarifying what constitutes a "beneficial owner" for purposes of the Bad Actor Rules.
- *SEC Provides Guidance on the Definition of "Knowledgeable Employees"* (pg. 9). The SEC recently issued a No-Action Letter expanding the definition of "knowledgeable employees," increasing the pool of employees who may be permitted to invest in certain private funds.
- *SEC Charges Manhattan-Based Private Equity Manager with Stealing $9 Million in Investor Funds* (pg.13). The SEC charged a Manhattan-based private equity manager and his firm with stealing $9 million from investors through an elaborate sham due diligence arrangement, in which the stolen monies were later used for kick-backs to secure investments from pension funds and rent luxury office space to project a more successful image.
- *SEC Announces Charges Against Arizona-Based Fund Manager in Expense Misallocation Scheme* (pg. 15). In February, the SEC announced charges against an Arizona-based private equity fund manager and his advisory firm in connection with a scheme to misallocate their expenses to the funds they manage.

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SEC Updates Form PF "Frequently Asked Questions" (pg. 7). The SEC recently released an updated set of questions and answers in its "Frequently Asked Questions" relating to Form PF, including several clarifications that may be useful to private fund advisers.

SEC Staff Offers Guidance on Exemption for Advisers to Venture Capital Funds (pg. 8). The SEC recently released guidance for investment advisers relying on the "Venture Capital Exemption," addressing issues with respect to intermediate holding companies, alternative investment vehicles, warehousing investments, side funds and liquidating trusts.

SEC Provides Guidance on the Definition of "Knowledgeable Employees" (pg. 9). The SEC recently issued a No-Action Letter expanding the definition of "knowledgeable employees," increasing the pool of employees who may be permitted to invest in certain private funds.

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SEC Releases Guidance on the Testimonial Rule and Social Media (pg. 10). The SEC recently provided guidance regarding the application of the rule that prohibits investment advisers from using testimonials in their advertisements with respect to advertisements that features public commentary about such advisers on independent, third-party social media sites.

SEC Releases New Guidance on Form 13F Confidential Treatment Requests (pg. 12). The SEC recently provided guidance regarding requests for confidential treatment for information relating to an ongoing program of acquisition or disposition of a security report on Form 13F, by identifying specific information that may be helpful to the SEC staff in determining whether such information should be treated as confidential.

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Status of Certain Private Fund Investors as Qualified Clients (pg. 12). The SEC recently provided guidance to firms that operate as a single advisory business through related investment advisers with respect to the aggregation of investments made by certain advisers for purposes of determining whether such investors are "qualified clients."

Examination and Enforcement Actions Developments

SEC Charges NY-Based Money Manager and Firm for Misleading Advertisements (pg. 13). The SEC recently charged a NY-based money manager and his firm with making false and misleading claims about the success of the funds they manage and their securities recommendations through social media outlets, widely disseminated newsletters and other communications.

SEC Charges Manhattan-Based Private Equity Manager with Stealing $9 Million in Investor Funds (pg. 13). The SEC charged a Manhattan-based private equity manager and his firm with stealing $9 million from investors through an elaborate sham due diligence arrangement, in which the stolen monies were later used for kick-backs to secure investments from pension funds and rent luxury office space to project a more successful image.

SEC to Focus on "Broken Windows," Targeting Both Large and Small Violations of Federal Securities Laws (pg. 14). The SEC Chairperson recently stated that one of the SEC's goals for its enforcement programs in the future is to pursue all types of violations of federal securities laws, big and small – signaling that while the SEC would continue to pursue the biggest frauds cases, it would also target more minor violations, such as control failures and negligence-based offenses.

SEC Fines Adviser for Inadequate Policies Governing Valuation and Cross Trades (pg. 14). The SEC recently imposed a $250,000 sanction on a hedge fund adviser for failing to adopt and implement compliance policies and procedures reasonably designed to prevent violations of the Advisers Act concerning valuations and cross trades between clients.

SEC Issues First Exemptive Order under Pay-to-Play Rule (pg. 15). The SEC issued its first order granting exemptive relief to an investment adviser under the pay-to-play rule, based on a number of factors relating to the investment adviser and the circumstances surrounding the political contribution.

SEC Announces Charges Against Arizona-Based Fund Manager in Expense Misallocation Scheme (pg. 15). In February, the SEC announced charges against an Arizona-based private equity fund manager and his advisory firm in connection with a scheme to misallocate their expenses to the funds they manage.

European Commission Decision Implicated the Parental Liability of Private Equity Funds. Earlier this month, the European Commission penalized a group of high voltage power cable producers for operating as an illegal cartel and additionally penalized the Goldman Sachs Group, Inc., under a theory of derivative parental liability because one of Goldman's private equity funds owned one of the cable producers (pg. 16).

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Regulatory Developments

SEC Releases National Examination Program's Examination Priorities for 2014

On January 9, 2014, the U.S. Securities and Exchange Commission (the SEC) National Examination Program (the NEP) of the Office of Compliance Inspections and Examinations published its 2014 examination priorities for NEP-wide initiatives for investment advisers. These priorities reflected topics that the SEC staff perceives to have heightened risk and to which the NEP expects to allocate significant resources throughout 2014.

The NEP-wide initiatives include:

- Using quantitative and qualitative tools to enhance fraud detection and prevention;
- Meeting with senior management and boards of SEC-registered entities and their affiliates to examine corporate governance, conflicts of interest and enterprise risk management;
- Examining technology systems and controls, information security and the ability to respond to sudden malfunctions and system outages (business continuity plans);
- Examining dual registrants (i.e., the convergence of broker-dealer and investment adviser businesses), and conflicts of interests and other issues that this business model presents;
- Examining issues relating to new laws and regulations (including general solicitation practices and verification of accredited investor status under newly adopted Rule 506(c) of the Securities Act of 1933 (as amended, the Securities Act), industry developments and compliance with new rules; and
- Examining sales practices involving retirement investments and rollovers, including potential misrepresentation of credentials, IRA plan features and suitability of investments.

The NEP also announced its priorities that are specifically applicable to registered investment advisers, including priorities that relate to (1) core risks, (2) new and emerging risks and (3) policy topics:

- *Core Risks*. Core risks are those risks that are common to the business models of a category of registrants and that have existed for a sustained period and are likely to continue for the foreseeable future. The Investment Adviser/Investment Company Program (the IA-IC Program) core risk initiatives include (i) testing compliance with Rule 206(4)-2 (the Custody Rule) under the Investment Advisers Act of 1940 (as amended, the Advisers Act) and confirming the existence of assets through a risk-based asset verification process; (ii) examining conflict-of-interest risks in compensation arrangements, allocation of investment opportunities, side-by-side management of performance-based and purely asset-based fee accounts, illiquid investments, leveraged investment strategies, and higher risk strategies targeted to retail investors; and (iii) reviewing advisers' claims about their investment objectives and performance and reviewing marketing efforts arising out of newly effective rules under the Jumpstart Our Business Startups Act of 2012.
- *New and Emerging Risks*. New and emerging risks are those arising from changes and developments in the industry. New and emerging risk initiatives for the IA-IC Program include (i) examining never-before examined and newly registered advisers; (ii) assessing whether advisers are fulfilling their obligations in relation to wrap fee programs; (iii) examining advisers that rely substantially on quantitative trading models; (iv) reviewing the payments made by advisers and funds to distributors and intermediaries and related disclosure and board oversight to assess whether such payments are "payments for distribution in guise"; and (v) monitoring the risks associated with a changing interest rate environment and its impact on bond funds and related risk disclosures.

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- *Policy Topics*. Policy topics are areas in which the SEC seeks to gain a better understanding of business practices and the application of previously adopted rules and guidance. The IA-IC Program policy topics include (i) money market funds, with focus on the management of potential stress events and funds that exhibit outlier behavior; (ii) funds offering "alternative" investment strategies; and (iii) securities lending arrangements to assess compliance with exemptive orders and no-action letters.

In connection with their annual review, registered investment advisers should review the policies, procedures and practices in light of the NEP IA-AC Program to ensure they are in compliance with the topics that will likely be the focus of examinations in 2014.

The full examination priorities publication can be found here.

SEC Initiative Announced to Target Registered Investment Advisers Who Have Never Undergone Review

The SEC recently announced its 2014 plan to target registered investment advisers who have never undergone a formal compliance examination. SEC Inspections Chief Andrew Bowden recently stated in a meeting of the Regulatory Compliance Association that the SEC plans to prioritize the review of the approximately 4,400 registered investment advisors who have never faced an SEC exam. Mr. Bowden noted it specifically intended to focus on the about half of those advisers that have been registered for more than three years and are domiciled in the U.S.

While some advisers and adviser trade associations have welcomed the SEC's initiative to step up exams, citing the increased standardization and fairness across the industry that would come as a result of the exams, others have expressed doubt that the SEC will have the proper management and resources to fulfill these ambitious goals.

Registered investment advisers that (i) have been registered for more than three years, (ii) are domiciled in the U.S. and (iii) have never faced an SEC exam should be aware that the SEC may be targeting this group for exams in the upcoming year.

SEC Chairperson Addresses "SEC Speaks" 2014

In February, SEC Chairperson Mary Jo White gave a speech to kick off the 2014 "SEC Speaks" event held in Washington, DC addressing generally the state of the SEC in 2013 and upcoming priorities and initiatives for 2014. In her speech, Chairperson White highlighted the three primary priorities that were set by the SEC in 2013, including (i) implementation of Congressional rulemaking under the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act); (ii) intensifying the SEC's efforts to ensure that the U.S. equity markets were operating to best serve the interest of all investors, and (iii) strengthening the enforcement program; and discussed upcoming priorities for 2014.

First, Chairperson White highlighted the progress made by the SEC with respect to the various rules adopted to implement the Dodd-Frank Act and identified many of the specific rules and regulations the SEC adopted in 2013, including (among others), (i) identity theft rules to detect red flags and prevent identity theft; (ii) reforms to the private offering market mandated by the Dodd-Frank Act, including lifting the ban on general solicitation; (iii) "bad actor" rules disqualifying bad actors from certain private offerings; (iv) financial responsibility rules for broker-dealers; (v) rules governing the registration and regulation of municipal advisors; (vi) regulations implementing the Volcker Rule; and (vii) rules to govern cross-border swap transactions in the over-the-counter derivatives market.

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Second, Chairperson White also noted the SEC's dedication to enhancing investor protection in 2013, including the consideration of the role and duties of investment advisers. Chairperson White noted that the SEC will also continue to engage with other domestic and international regulators to ensure that the risks that are interconnected among many financial systems are identified, addressed and appropriately monitored; and she stated that in 2014 the SEC will continue to prioritize the review of the equity market structure, focusing on how it impacts investors and companies of every size.

Chairperson White then discussed the enforcement program results from 2013, noting that the SEC modified its long-standing no admit/no deny settlement protocol and now requires admissions in a broad range of cases. Additionally, in 2013 the SEC increased its focus on accounting fraud through the creation of a new task for (the Financial Reporting and Audit Task Force) whose goal was to examine new trends or patterns of conduct that may be risk indicators for financial fraud.

Finally, Chairperson White discussed some new priorities for 2014, including (i) an initiative to begin focusing more on the public markets as well as the private markets, (ii) increased risk monitoring and data analytics activities and (iii) the use of powerful new data analytics and technology tools in its National Examination Program to conduct more effective and efficient risk-based examinations on registrants. The full text of Chairperson White's speech is available here.

SEC Issues New Guidance to Clarify the Term "Beneficial Owner" in Bad Actor RulesEC Issues Clarifies "Beneficial Owner" for Bad Actor Rules

The SEC's Division of Corporate Finance (the Division) has recently issued new guidance (in the form of "Frequently Asked Questions") to clarify what constitutes a "beneficial owner" for the purposes of Rule 506(d) of the Securities Act (the Bad Actor Rule). Generally, the Bad Actor Rule disqualifies issuers from relying on the exemptions set forth in Rule 506 of the Securities Act if such issuers have "covered persons" who have engaged in certain "disqualifying events." "Covered persons" includes 20% beneficial owners of the issuer for purposes of the Bad Actor Rule.

Consistent with its informal oral guidance the Division had been providing to the industry, the Division clarified that for purposes of the Bad Actor Rules, a "beneficial owner" is interpreted the same way as under Rule 13d-3 of the Securities Exchange Act of 1934 (as amended, the Exchange Act). Therefore, a "beneficial owner" generally includes any person who, directly or indirectly (through any contract, arrangement, understanding or otherwise) has or shares, or is deemed to have or share (i) voting power (including the power to vote or direct the vote of such security) and/or (ii) investment power (including the power to dispose or to direct the disposition of such security). As a result, even larger limited partners may not be "beneficial owners" for purposes of the Bad Actor Rules if they don't have the power to vote or investment power.

In its guidance, the Division further concluded that the disclosure obligations in Rule 506(e) requiring issuers to disclose to investors any disqualifying events that occurred prior to September 23, 2013 are not waived by the procedures in Rule 506(d)(2)(iii). Rule 506(d)(2)(iii) generally allows issuers to avoid disqualification by delivering an order of a regulator or court advising the SEC that a Rule 506 disqualification should not occur because the disqualifying event occurred on or after September 23, 2013. Thus, while a disqualification can be lifted by such an order, the obligation to disclose such disqualification remains.

In light of the clarifying guidance, firms should require all appropriate covered persons complete their "Bad Actor Questionnaires" and ensure any appropriate disclosures are made with respect to any disqualifying event occurring prior to September 23, 2013.

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Treasury International Capital Form SHL and Form S Updated

The Department of Treasury recently released updated instructions and forms with respect to the Treasury International Capital Form SHL (Form SHL) and the Treasury International Capital Form S (Form S). A description of the updates to each form is below.

Form SHL. Form SHL generally requires U.S. resident issuers (i.e., U.S. funds) and U.S. resident custodians to report information regarding the ownership of reportable U.S. securities by foreign residents.[1] U.S. resident issuers must report all securities they issue that are owned by foreign residents for which neither a U.S. resident custodian nor a U.S. resident central securities depository is used. U.S. resident custodians must report all U.S. securities they hold in custody for the accounts of foreign residents.

Form SHL is a two-part report. Schedule 1 to Form SHL requires the U.S. resident issuer or custodian report basic identifying information about itself. Schedule 2 to Form SHL must be completed by a U.S. resident issuer if the total fair value of all U.S. reportable securities held by foreign owners (excluding any securities held with a U.S. resident custodian) in the aggregate and on a consolidated basis equals or exceeds $100 million. If the threshold is met, a separate Schedule 2 must be completed for each foreign resident holder of a U.S. reportable security.

Schedule 2 to Form SHL requires detailed information regarding the U.S. reportable securities and their foreign resident owner.

Form SHL is filed every five years. Data as of June 30, 2014 must be reported no later than the last business day of August (August 29, 2014). A copy of Form SHL and the Instructions are available here.

Form S. Earlier this year, the Federal Reserve Bank of New York released updated instructions to Form S increasing the exemption level for filing from $50 million to $350 million. More specifically, prior to June 30, 2014, Form S was required to be filed by U.S. residents who engaged in transactions directly with foreign residents that result, in the aggregate, of $50 million or more of cash being exchanged for long-term securities in a reporting month. Following the revisions, for reports due after June 30, 2014, Form S is required to be filed by U.S. residents who engage in transactions directly with foreign residents that result, in the aggregate, of $350 million or more of cash being exchanged for long-term securities in a reporting month. Notwithstanding the increased exemption threshold, in the event a U.S. resident breached the $50 million prior to June 30 (and thus had previously filed a Form S in 2014), the U.S. resident is required to continue filing for the remainder of the calendar year, even if the new threshold is not met.

A copy of the updated Form S instructions is available here.

SEC Updates Form PF "Frequently Asked Questions"

The SEC staff recently released an updated set of questions and answers in its "Frequently Asked Questions" relating to Form PF, and several of these clarifications may be useful to private fund advisers. Among the updates, the SEC noted a few situations that may require clarifying remarks in Question 4 and clarified the reporting of values of assets and liabilities in Question 14.

For instance, the SEC clarified when an adviser should indicate whether it has disregarded or included a reporting fund's investment in other private funds for purposes of reporting on Form PF in Question 4. Also, the SEC confirmed that a private fund may be deemed to be a hedge fund if its organizational

[1] Reportable securities include equity securities (including fund interests), short-term debt securities (including selected money market instruments), long-term debt securities and asset-backed securities. Reportable securities may be traded or issued in the United States or foreign countries and may be denominated in any currency.

documents allow the fund to either employ large amounts of leverage or sell assets short, regardless of whether the fund actually utilizes the leverage or engages in short sales. However, the SEC noted that if a private fund is represented to investors as a type of fund other than a hedge fund (i.e., a private equity fund, a real estate fund, or a venture capital fund), the adviser may include a note in Question 4 indicating (i) the category of private fund the adviser believes better describes the fund and (ii) why the reporting fund meets the definition of a hedge fund.

Additionally, the SEC clarified that with respect to reporting the value of assets and liabilities in Question 14, an adviser should include all assets and liabilities in the "cost-based" column that would be presented in a fund's financial statements that use a measurement attribute other than fair value. The SEC noted that the sum of the amount entered in the "assets" row in Question 14 should equal approximately the reporting funds gross assets reported in Question 8 (except for funds with uncalled commitments included in their gross assets) and similarly, the sum of the amount of "liabilities" entered in Question 14 should equal approximately the total liabilities reported on the fund's financial statements. The SEC further noted that cash and cash equivalents should also be included as "assets" for purposes of Question 14.

Form PF filers should review their Form PF filings (particularly Question 4) to determine whether any additional disclosure or clarification is necessary.

SEC Staff Offers Guidance on Exemption for Advisers to Venture Capital Funds

The SEC's Division of Investment Management (the Division) recently released guidance regarding the registration exemption for investment advisers to venture capital funds (as defined in Rule 203(l)-1) of the Advisers Act (the VC Exemption). The guidance highlights five scenarios illustrative of the inquiries the Division has been receiving with respect to reliance on the VC Exemption and is generally helpful to investment advisers and sponsors.

In one scenario, the Division noted it would not object to an investment adviser relying on the VC Exemption if an intermediate holding company exists in the venture capital funds' structure, so long as the intermediate holding company is wholly owned collectively by one or more venture capital funds advised by the same investment adviser. The Division further clarified that for purposes of the definition of a "qualifying portfolio company," a venture capital fund may disregard such an intermediate holding company formed solely for tax, legal or regulatory reasons to hold the fund's investment in a qualifying portfolio company.

In another scenario, the Division clarified that it would not object if an investment adviser relying on the VC Exemption disregarded an alternative investment vehicle when determining if it could meet the requirements of the VC Exemption so long as such alternative investment vehicle was formed solely to address investors' tax, legal or regulatory concerns, and the sole purpose of the alternative investment vehicle is to invest in a venture capital fund.

In the other scenarios, the Division addressed issues regarding warehoused investments, side funds and liquidating trusts. The full text of the guidance is available here.

Investment Advisers relying on the VC Exemption should review the guidance to ensure they are treating all entities within their venture capital structure appropriately for purposes of the VC Exemption.

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SEC Provides Guidance on the Definition of "Knowledgeable Employees"

In February, the SEC's Division of Investment Management (the Division) issued a very helpful No-Action Letter to the Managed Funds Association that provided guidance on the definition of "knowledgeable employees" under the Investment Company Act of 1940 (as amended, the Investment Company Act). Generally, under Rule 3c-5 of the Investment Company Act (the Rule), a "knowledgeable employee" of a private fund (a Covered Fund), or a "knowledgeable employee of an affiliated person that manages the investment activities of a Covered Fund" is permitted to invest in a Covered Fund without being counted for purposes of the 100-person limit in Section 3(c)(1) of the Investment Company Act, regardless of whether the knowledgeable employee would be a "qualified purchaser" for purposes of Section 3(c)(7) of the Investment Company Act. As a result, the No-Action Letter generally expanded the pool of possible employee investors in Covered Funds by providing the following guidance:

Executive Officers and Policy-Making Employees. The first category of "knowledgeable employees" of a Covered Fund includes any natural person who is an executive officer, director, trustee, general partner, or person serving in a similar capacity of a Covered Fund or the investment adviser of such Covered Fund. An "executive officer" is defined as (i) the president or a vice president of a "principal business unit, division or function", or (ii) any other person who performs similar policy-making functions for a Covered Fund. The No-Action Letter provided guidance as to what parts of an adviser's business may be deemed to be a "principal" unit, division or function, as well as clarifying the definition of "executive officers":

- Principal Status. The Division noted that the "principal status" of an investment adviser's business unit, division or function depends on the facts and circumstances and must be made on a case-by-case basis, further clarifying that while not all business units, divisions or functions are necessarily "principal", it is possible that several business units, divisions or functions could be deemed to have "principal status" depending on the facts and circumstances. The No-Action Letter highlighted as an example that an investment adviser could determine that its IT and investor relations departments are principal business units, divisions or functions under certain circumstances and therefore, the individual(s) in charge of each such department may be deemed to be "knowledgeable employees".
- Executive Officers. Under the Rule, an "executive officer" is deemed to be any officer or other person who has the power to make, and actually makes, policy decisions on behalf of an investment adviser. In the No-Action Letter, the Division clarified that employees who serve policy-making functions may be deemed to be an "executive officer" regardless of their specific title. Specifically, an employee who does not have a senior management title may be still be deemed to be a "knowledgeable employee" under the Rule if he or she makes policy through the day-to-day involvement in the development and adoption of an investment adviser's policies.

Participating in Investment Activities of a Covered Fund. The second category of "knowledgeable employees" of a Covered Fund includes any person who, in connection with his or her regular duties and functions, participates in the investment activities of such Covered Fund. The No-Action Letter clarified when an employee participating in the investment activities of a Covered Fund would be a "knowledgeable employee":

- *Participating in Part of a Portfolio*. The No-Action Letter provided that an employee may be deemed to be "participating in the investment activities of a Covered Fund" even if his or her functions relate only to a portion of the portfolio of the Covered Fund, instead of the entire fund. As an example, a research analyst who researches and provides analysis and advice only with respect to a portion of the portfolio of a private fund may also be deemed to be a "knowledgeable employee", as such analyst is

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participating in the investment activities of the Covered Fund. The ultimate determination of whether an individual "participates in the investment activities of a Covered Fund" is a factual determination that must be made on a case-by-case basis.

- *Separate Accounts*. The Division further clarified that for purposes of the Rule, an employee that participates in the investment activities of separate accounts may be treated as a "knowledgeable employee", notwithstanding the fact that such employees does not participate in the investment activities of a Covered Fund, so long as (i) the separate account is established for a client that is a "qualified client", (ii) the separate account is otherwise eligible to invest in the private fund advised by the investment adviser, and (iii) the separate account pursues an investment strategy substantially similar to one pursued by one or more funds managed by the investment adviser.

The Division concluded by noting that investment advisers will be required to make determinations as to which employees qualify as "knowledgeable employees" based on the facts and circumstances relevant to their business. The Division further suggested that investment advisers should appropriately maintain, in their books and records, a written record of employees that are permitted to invest in a Covered Fund as a "knowledgeable employee" and the basis of such qualification as a "knowledgeable employee."

This expanded definition of "knowledgeable employees" may be helpful for investment advisers wanting to ensure their employees are able to invest in their funds without running afoul of the exemptions set forth in Section 3 of the Investment Company Act. We note that the analysis is very fact-specific, and each situation should be carefully reviewed in light of the new guidance.

House Passes Bill Exempting Private Advisers from Registration

The House of Representatives recently passed a bipartisan bill, H.R. 1105 (the Bill), that would exempt most private equity fund advisers from registering with the SEC, as currently required under the Dodd-Frank Act. As noted in a previous Ropes & Gray Alert, the Bill proposes to exempt from registration private advisers of funds with outstanding debt that is less than twice the amount of capital that has been committed to and invested by the fund. The Bill was passed 254-159 and was framed by Republicans and some Democrats as a "jobs-creation measure."

While the Bill was passed by the House of Representatives, it still faces substantial hurdles before being passed, including passage by the Senate. Additionally, the White House issued a statement opposing the Bill as "undermin[ing] advances in investor protection and regulatory oversight" implemented under Dodd-Frank and the SEC Chairman also criticized the Bill at the committee level in June for "narrow[ing] the scope of the commission's jurisdiction and oversight" of advisers. There is currently no Senate counterpart.

While we do not expect any changes in private equity fund adviser registration requirements in the near future, we will keep you apprised if this legislation moves forward.

SEC Releases Guidance on the Testimonial Rule and Social Media

The SEC recently provided guidance in a March IM Guidance Update regarding the application of Section 206(4) of the Advisers Act (the Testimony Rule) to the use of social media. In recognizing that the use of social media has increased the demand for independent third-party commentary and reviews for service providers (including investment advisers), the SEC's guidance is aimed at assisting investment advisers apply the rule that prohibits investment advisers from using testimonials in their advertisements with respect to advertisements that feature public commentary about such investment adviser on independent, third-party social media sites.

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The Testimony Rule generally prohibits an investment adviser from publishing, circulating or otherwise distributing "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." The purpose of this prohibition is to address the potential that a testimonial may give rise to a fraudulent or deceptive implication that the experience of a person giving the testimonial is not unique to such person. However, the SEC staff has clarified that an investment adviser's publication of an article by an unbiased third party regarding such investment adviser's performance would not be a testimonial unless it also included a statement of a client's experience with, or endorsement of, the investment adviser. In its guidance, the SEC further clarified its positions with respect to third-party commentary, the inclusion of advertisements on independent social media sites, client lists, and fan/community websites.

With respect to third-party commentary, the SEC staff clarified that an investment adviser may not publish public commentary that is an explicit or implicit statement of a client's experience with, or endorsement of, the investment adviser. However, an investment adviser may publish the same public commentary on its own social media site if it comes from an independent media site when (1) the independent social media site provides content that is independent of the investment adviser, (2) there is no material connection between the independent social media site and the investment adviser, and (3) the investment adviser publishes all commentary appearing on the independent social media site. The SEC staff distinguished these cases by noting that when an investment adviser does not have any ability to affect which public commentary is included, such public commentary is not restricted and all public commentary is viewable, then the concerns presented by the Testimony Rule may not be implicated. Further, the SEC noted that whether commentary is "independent" depends on the facts and circumstances of such commentary, with particular attention being paid to whether the commentary was directly or indirectly authored by the investment adviser, whether a material connection exists between the independent social media site and the investment adviser, and whether any compensation was provided to the independent social media site from the investment adviser.

With respect to inclusion of investment adviser advertisements on independent social media sites, the SEC noted that an investment adviser may publish commentary from an independent social media site, so long as the investment adviser complies with the "material connection" and "independence factors" described above. Thus, the inclusion of an advertisement from the investment adviser on an independent social media's site would not, in and of itself, cause the publication of the public commentary to violate the Testimony Rule.

In its guidance, the SEC also explained that while a list or photographs of "friends" on an investment adviser's social media site that is viewable by the general public is not generally a "testimonial", it is still an advertisement that may be false or misleading and would still therefore be in violation of the Advisers Act. For instance, if the investment adviser attempts to create the inference that the friends listed on such investment adviser's social media site experienced favorable results from the investment adviser, such a publication could be in violation of the Advisers Act.

Finally, the SEC clarified that persons unaffiliated with the investment adviser may establish various "community" or "fan" pages where the public may comment on a variety of investment topics, including the performance of the investment adviser, without violating the Testimony Rule. The SEC did, however, caution investment advisers to consider all relevant facts when determining whether to public such content on its own site.

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In light of this guidance, investment advisers should examine their advertising policy with respect to testimonials on social media to ensure they are compliant with various requirements highlighted in the guidance.

SEC Releases New Guidance on Form 13F Confidential Treatment Requests

In an October IM Guidance Update, the Division provided additional guidance regarding requests for confidential treatment for information relating to an ongoing program of acquisition or disposition of a security reported on Form 13F (an "ongoing acquisition/disposition program"). Section 13(f) of the Exchange Act generally requires investment managers who manage more than $100 million in certain reportable securities to file with the SEC quarterly reports on Form 13F detailing their holdings. Section 13(f) also requires the SEC to promptly disseminate information appearing in such quarterly reports to the public, but permits the SEC to delay or prevent the public disclosure of such information if it determines it to be in the public interest or for the protection of investors in accordance with the Freedom of Information Act (FOIA) and related rules.

In particular, SEC FOIA rules permit information that "disclose[s] trade secrets and commercial or financial information obtained from a person and is privileged or confidential" to be treated as confidential under Section 13(f), and, under this exception, filers commonly request confidential treatment of information that would reveal an investment manager's ongoing acquisition/disposition program.

In a 1998 staff letter, the SEC provided detailed guidance to Form 13F filers making requests for confidential treatment relating to an ongoing acquisition/disposition program and elaborated on the five categories of information required to be included in such a request: (i) details about the specific investment program being followed with respect to a reportable security and its ultimate objective; (ii) an explanation of how the public would be able to discern the investment manager's strategy with respect to the reportable security from the data reported on Form 13F; (iii) information demonstrating that the program is ongoing, so that public disclosure would be premature; (iv) a demonstration of the likelihood of substantial harm to the investment manager's competitive position in the reportable security if the request for confidential treatment is not granted; and (v) the period of time for which confidential treatment is requested.

In this context, the SEC's latest guidance identifies specific information within the five categories noted above that may be helpful to SEC staff in determining whether information relating to an ongoing acquisition/disposition program should be treated as confidential. For example, the guidance suggests that requests for confidential treatment should specifically explain the ongoing acquisition/disposition program's ultimate goal, including as a percentage of the reportable security issuer's total outstanding securities. The guidance also suggests that investment managers explain why public disclosure on Form 13F likely would reveal the program, notwithstanding that Form 13F disclosure generally provides only a historical "snapshot" of aggregated holdings in the reportable security. **Investment managers seeking confidential treatment of information in their Form 13F filings relating to ongoing acquisition/disposition programs should take this guidance into account when considering requests for confidential treatment.** This new guidance may be found here.

Status of Certain Private Fund Investors as Qualified Clients

The SEC recently provided guidance in response to questions received from firms that operate as a single advisory business through related investment advisers (formed as separate legal entities and together, a Firm) regarding the aggregation of investments of certain investors to determine whether such investors are "qualified clients" as defined in Rule 205-3 of the Advisers Act.

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Specifically, clarification was requested on how to treat investors that made investments into more than one separate private fund, where each fund was advised by separate, but related, investment advisers. The SEC confirmed that it would not object if an investment adviser aggregated an investor's investments in all private funds advised by the related investment advisers that comprise a Firm to determine whether the investor has reached the $1,000,000 threshold necessary to be deemed to be a "qualified client." The full text of the guidance may be found here.

Examination and Enforcement Actions Developments

SEC Charges NY-Based Money Manager and Firm for Misleading Advertisements

In January, the SEC charged a NY-based money manager and his firm for making false and misleading claims about the success of the funds they manage through social media outlets, widely disseminated newsletters, and other communications. The SEC Order (the Order) against Mark A. Grimaldi (Grimaldi) and Navigator Money Management (NMM) found that Grimaldi and NMM were selective in advertising the past performance of various funds and specific securities recommendations they made to clients. Specifically, the Order claimed that they cherry-picked the highlights of their successes, but ignored less successful recommendations and fund performance.

According to the Order, Grimaldi (the majority owner, president and chief compliance officer of NMM) used certain newsletters to solicit investors, and such newsletters were deemed to be "advertisements" by the SEC. In its examination, the SEC found that the newsletters contained several misleading claims about the funds NMM managed, its performance and rankings within the industry. The Order also charged Grimaldi with making statements on Twitter, with respect to the level of his involvement in a highly successful portfolio.

The Order found that Grimaldi and NMM violated various sections of the Securities Act, the Advisers Act and the Investment Company Act. Grimaldi and NMM both agreed to settle the charges with the SEC. Grimaldi agreed to pay a penalty of $100,000, and he and NMM agreed to be censured and comply with certain requirements imposed by the SEC, including the retention of an independent compliance consultant for three years. Without admitting or denying the SEC's finding, Grimaldi and NMM were also required to cease from any future violations that they were charged with in the order.

In connection with the investigation, SEC staff members emphasized the requirement that investment advisers be honest and provide a full picture of their investment recommendations in their advertising in order to give investors the full picture prior to making an investment.

Advisers are cautioned to carefully review all advertising materials to ensure they are not "cherry-picking" investment highlights and instead provide an accurate and fulsome picture for prospective investors.

SEC Charges Manhattan-Based Private Equity Manager with Stealing $9 Million in Investor Funds

The SEC recently charged a Manhattan-based private equity manager and his firm with stealing $9 million from investors in their private equity fund. The SEC complaint claims that Lawrence E. Penn III (Penn) and a longtime acquaintance developed a sham due diligence arrangement whereby Penn used fund assets to pay fake fees to a company controlled by his acquaintance. However, instead of conducting any due diligence with respect to potential investments, the company used the fees to kick money back to companies and accounts controlled by Penn for other purposes. The SEC further alleged that Penn paid significant

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commission to third parties to secure investments from pension funds and rented luxury office space to project the image that his firm, Camelot Acquisitions Secondary Opportunities Management (Camelot) was a thriving international private equity operation.

According to the SEC's complaint, Penn stole approximately $9.3 million of investor assets and repeatedly misled Camelot's auditors about the nature and purpose of the due diligence fees. When Camelot's auditors increasingly questioned the arrangement about the fees and in an effort to cover their tracks, Penn also lied to the auditors and forged documents to prove the fees were valid.

The SEC's complaint charges Penn, Camelot and other associated persons and entities with violating the antifraud, books and records, and registration application process of securities laws. The SEC was able to obtain an emergency court order to freeze the assets of Penn and Camelot, as well as the other individuals and entities involved in the sham arrangement. The complaint seeks a final judgment that would require the guilty parties to disgorge ill-received gains with interest, pay financial penalties and be barred from future violations of the antifraud provisions of securities laws. The SEC's complain is available here.

SEC to Focus on "Broken Windows," Targeting Both Large and Small Violations of Federal Securities Laws

In recent remarks to the Securities Enforcement Forum, SEC Chairperson Mary Jo White stated that one of the SEC's goals for its enforcement program is to be "everywhere, pursuing all types of violations of our federal securities laws, big and small." She likened the approach to the "broken windows" policy pursued during the 1990s by then-New York City Mayor Rudy Giuliani, who regarded no infraction too small to be "uncovered and punished". Chairperson White noted that the SEC's Division of Enforcement would pursue not just the biggest frauds, but also more minor violations such as control failures and negligence-based offenses, among others.

As an example of the SEC's efforts to target violations and violators regardless of size, Chairperson White noted the nearly two dozen enforcement actions brought by the SEC for violations of Rule 105 of Regulation M, which prohibits improperly participating in public offerings for a period of time after short-selling those same securities (a link to a related Ropes & Gray Alert can be found here). She noted that these actions yielded disgorgements ranging from as high as $2.5 million to as low as $4,000. Chairperson White subsequently tempered her comments with regard to minor violations, noting that "it's not a game of gotcha" and that the SEC does not seek to bring an enforcement action in response to every minor violation, but intends to address such violations through engagement, deficiency letters, and other approaches short of enforcement action.

Chairperson White stated that while the SEC intends to target smaller violations, it will continue to focus significant attention on larger and more complicated cases. She noted that the SEC will strive for settlements "that have a deterrent effect, and where appropriate, the added measure of public accountability that an admission often brings." Chairperson White's full speech can be found here.

SEC Fines Adviser for Inadequate Policies Governing Valuation and Cross Trades

In November of 2013, the SEC imposed a $250,000 sanction on Agamas Capital Management, L.P. (Agamas), a hedge fund adviser, for failing to adopt and implement compliance policies and procedures reasonably designed to prevent violations of the Advisers Act concerning (i) the valuation of fund assets, (ii) the accuracy of valuation disclosures, and (iii) cross trades between clients. While Agamas had adopted detailed valuation procedures, the SEC concluded that it failed to fully document the basis for use of discretion in pricing certain securities, consistently discarding a higher number of low quotes than high

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quotes. Although the purchasing fund ultimately profited from certain of the cross trades at issue, the positions were sold when there were no other acceptable offers, and the SEC sanctioned Agamas for failure to adopt written policies and procedures to determine the pricing of the cross trades and manage conflicts of interest.

SEC Issues First Exemptive Order Under Pay-to-Play Rule

In November of 2013, the SEC issued its first order granting exemptive relief to an investment adviser under the pay-to-play rules. The pay-to-play rule generally prohibits investment advisers from receiving compensation from a government entity within two years after the adviser (or a covered associate) makes a political contribution to such government entity. The pay-to-play rule also allows the SEC to exempt an investment adviser from the two-year prohibition based upon a number of factors.

In May of 2011, a senior investment professional of the adviser requesting relief made a $2,500 contribution to a federal congressional campaign of an official who was able to appoint a majority of trustees on the boards of the investment adviser's pension fund clients. The investment professional did not pre-clear this contribution, as was required under the adviser's policies and procedures, because he mistakenly believed contributions to federal campaigns were permissible and not subject to pre-clearance. When the adviser's compliance department later discovered the contribution through random testing of publicly available contribution databases, the adviser and the investment professional arranged for the return of the investment professional's contribution.

In the meantime, the adviser notified its clients of the contribution and established an escrow account for all compensation received from clients for the two-year period beginning as of the date the contribution was made, pending exemptive relief from the SEC.

The SEC granted the adviser's application for an exemption based on representations made by the adviser, including that the investment professional's contact with clients was limited, the government official's influence on each client was limited, it was is in the best interest of the clients to permit the advisory relationship to continue, the adviser adopted appropriate policies and procedures prior to the contribution and was appropriately monitoring contributions, the adviser and investment professional obtained the return of the contribution and the investment professional did not intend to influence the clients in making the contribution.

This relief provides insight into the types of factors the SEC may consider in making determinations for future applications of relief.

SEC Announces Charges Against Arizona-Based Fund Manager in Expense Misallocation Scheme

In February, the SEC announced charges against an Arizona-based private equity fund manager and his advisory firm in connection with a scheme to misallocate their expenses to the funds they managed. In an order against Scott A. Brittenham (Brittenham) and Clean Energy Capital (CEC) (the Order) the SEC Enforcement Division alleged that Brittenham and CEC improperly allocated more than $3 million of CEC's expenses to 19 private equity funds that invest in private ethanol production plants. The Order charges CEC and Brittenham with willfully violating the antifraud provisions of the federal securities laws and also assets additional violations with respect to disclosure, compliance, custody and reporting.

According to the Order, in addition to the misallocation of expenses, CEC and Brittenham engaged in a variety of fraudulent behaviors, including (i) misallocating CEC's rent, salaries and other employee benefits,

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including tuition costs, retirement and bonuses; (ii) using fund assets to pay to Brittenham 70 percent of a $100,000 bonus he awarded to himself; (iii) making unauthorized loans to the funds at exorbitant interest rates (up to 17%) in order to continue paying the improper expenses with fund assets; (iv) profiting at the expense of fund investors by unilaterally changing how CEC calculated distributions to investors in order to pay out less money; and (v) substantially inflating the amount that Brittenham and CEC's co-founder had each invested in a fund. The Order is available here.

European Commission Decision Implicates the Parental Liability of Private Equity Funds

Overview and Background. Earlier this month, the European Commission penalized a group of high voltage power cable producers for operating as an illegal cartel and additionally penalized the Goldman Sachs Group, Inc. (Goldman) under a theory of derivative parental liability because one of Goldman's private equity funds owned Prysmian, one of the cable producers. Prysmian, an Italian company, is the world's top cable producer and was acquired by Goldman through one of its private equity funds in 2005. The fund reduced its ownership in Prysmian to a 43% minority share in 2007 and had completely divested its ownership by 2010.

The European Commission fined the infringing cable producers and also issued a €37.3 million (approximately $50 million) fine to Goldman, highlighting the European Commission's position that private equity firms and funds may be exposed to liability for illegal activities by their portfolio companies, even when the funds are involved only in the high-level commercial policies of such companies.[2]

Parental Liability. The European Commission's decision reflects a trend of expanding parental liability in the European Union (the EU), and it has become increasingly common for parent entities to be fined for violations of their subsidiaries. In the EU, a parent entity may be held liable for the illegal activity of a subsidiary or portfolio company if it exercises "decisive influence" over the infringing entity, which may be based on any economic, organizational or legal link. The European Commission considers a variety of factors that may show practical influence over another entity, including significant involvement at the board level, the right to appoint senior managers, veto rights over matters such as the annual budget or business plans and commonality of assets, systems and employees. Further, the European Commission does not require that the parent entity be involved in the illegal behavior of the infringing entity; it is sufficient if the parent entity exercises influence over the infringing entity's commercial policies in general. Therefore, a parent entity may be held derivatively liable for the illegal activities of its subsidiaries or portfolio companies despite having only a minority ownership or no legal ownership interest at all and having no involvement in the purported illegal activity.

Consistent with this trend, the European Commission fined Goldman even though it has not suggested that Goldman or its employees had any knowledge or involvement in Prysmian's collusive behavior. Instead, the European Commission found Goldman liable based only on its determination that Goldman, through the private equity fund that owned Prysmian, exercised "decisive influence" over Prysmian during the years of its ownership, including for the period in which it did not own a majority share. According to the European Commission's public statements, Goldman had "direct involvement" in Prysmian's management because (i) it appointed members of the Prysmian board who approved important strategic decisions and (ii) it was regularly updated about Prysmian's business operations. The European Commission further emphasized that financial investment companies have a responsibility to look closely at whether their portfolio companies comply with EU laws and to take steps to ensure that a "compliance culture" exists within those companies.

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[2] The formal written decision of the European Commission has not yet been published due to confidentiality issues.

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Implications for Private Funds. The European Commission's approach to parental liability is very different from the framework applied by courts in the United States. In the United States, if a parent entity is not directly involved in the illegal activity at issue, courts generally may pierce the corporate veil only if the infringing entity is exclusively and completely dominated by the parent. The EU's "decisive influence" test allows for much broader liability. Thus, private funds holding EU-based portfolio companies may wish to consider taking certain additional steps to limit exposure for derivative parental liability, including (to the extent it is commercially feasible):

- Due Diligence. The due diligence stage prior to making an investment presents the best opportunity for funds to evaluate the risk that their portfolio companies may be engaging (or may in the future engage) in illegal activities, including infringement of European competition laws).
- Contractual Arrangements. Firms should consider including in their funds' deal documents (a) indemnity provisions that specifically cover potential competition law violations by a portfolio company and (b) provisions that allocate liability to their portfolio companies in the event that penalties are levied for illegal activities.
- Independent Operations. Firms may want to limit their influence in the operations of their portfolio companies, specifically by (a) reducing their involvement at the board level, (b) giving up the right to appoint senior managers or veto certain matters such as the annual budget or business plans, and (c) reducing or eliminating any commonality of assets, systems and employees.

In light of the European Commission's recent decision, private equity firms should examine their European portfolio companies more closely to ensure such companies have sufficient compliance policies and procedures in place to identify and correct inappropriate behavior and should determine whether any additional steps should be taken to minimize parental liability in Europe.

Previously Issued Client Alerts

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

SEC Issues Guidance Regarding New General Solicitation Rules
November 19, 2013

CFTC Reproposes Rules on Position Limits for Futures and Swaps
November 26, 2013

SEC Issues Guidance on Bad Actor Rules
December 9, 2013

Two Months to Comply with European Reporting Rules for Derivatives – What Buy-Side Entities Need to Know
December 11, 2013

Volcker Rule Final Regulations: The Effect on Private Fund Sponsors and Investors
December 16, 2013

Upcoming Municipal Advisor Temporary Registration Deadline
January 8, 2014

Upcoming TIC Form B Filing Deadline
January 10, 2014

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SEC Clarifies Definition of Municipal Advisor for Registered Investment Advisers
January 10, 2014

Segregation of Initial Margin Posted in Connection with Uncleared Swaps: Considerations for the Buy Side
April 7, 2014

Reminder Regarding Upcoming FATCA Deadline and Implications for Trading Agreements
April 30, 2014

Ropes & Gray LLP Joins Firms in Volcker Rule Interpretation on Parallel Fund Structure
May 6, 2014

CFTC Staff Updates Requirements for Delegation of CPO Functions
May 14, 2014

AIFMD – What Actions Should Non-EEA Private Fund Managers Be Taking Now?
May 16, 2014

EMIR Reporting – Further Reporting Obligations Apply in August 2014
June 9, 2014

SEC Issues Guidance on Application of Custody Rules to Special Purpose Vehicles and Escrows
July 1, 2014

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