Federal Regulations Affecting Private Funds

Steven J. Gray

March 2016

Anti-fraud Provisions

- Investment funds, fund advisers and employees are subject to federal anti-fraud provisions in connection with the offering, sale, or purchase of securities
  - Rule 10b-5 of the Securities Exchange Act of 1934 (the "Exchange Act") prohibits fraud, manipulation and insider trading in connection with the purchase or sale of any security
    - Creates private right of action
  - Section 17(a) of the Securities Act of 1933 (the "Securities Act") prohibits false or misleading statements or other fraudulent conduct in connection with the offer or sale of securities
  - Funds can potentially be liable for securities fraud in connection with:
    - the offer and sale of fund interests
    - sale of portfolio investments
    - trading of marketable securities
  - Potential aiding and abetting liability for fund managers and employees
  - States maintain similar anti-fraud provisions
- Rule 206(4)-8 of the Investment Advisers Act prohibits an adviser to a fund from making any false or misleading statement to, or otherwise defrauding, any investor or prospective investor in the fund
  - Covers registered and exempt advisers to private funds
  - Applies to all communications in offering materials, RFPs and personal meetings
  - Creates liability for false statements regarding investment strategies, experience, investment risks, prior performance, valuations, and investment allocations among multiple funds

Anti-Money Laundering

- Bank Secrecy Act and USA Patriot Act have long required financial institutions to maintain anti-money laundering ("AML") programs and report suspicious activity
- Most private fund managers have developed voluntary AML programs and screening as a best practice or as part of OFAC economic and trade sanctions compliance
- U.S. Treasury's Financial Crimes Enforcement Network has proposed rules requiring registered investment advisers to establish AML programs
  - AML programs to include:
    - Written policies, procedures and internal controls
    - Independent testing
    - Designated compliance officer
    - Ongoing training
    - Reporting of suspicious activity
- Likely to involve SEC oversight and potential penalties and enforcement actions
- As proposed, will not apply to private fund advisers managing less than $150 million from a place of business in the U.S.

Customer Privacy

- Gramm-Leach-Bliley Act regulates information privacy practices of financial institutions with respect to nonpublic personal information
  - Covers investment advisers and private funds
  - Requires financial institutions to:
    - Safeguard and prevent unauthorized access to customer records and information
    - Provide notice of disclosure practices to affiliated and non-affiliated parties
    - Allow customers to opt-out of disclosures to unaffiliated third parties
  - Applies only to individuals, not entities
  - Implemented through SEC Regulation S-P and regulations of the Consumer Financial Protection Board ("CFPB") and the Federal Trade Commission ("FTC")
    - SEC Regulation S-P applies to registered investment companies and registered investment advisers
    - CFPB and FTC regulations apply to private funds and exempt private fund advisers
- Private funds and exempt private fund advisers should provide required notice of disclosure practices in offering documents or subscription agreements

Foreign Corrupt Practices Act

- Foreign Corrupt Practices Act imposes civil and criminal penalties on U.S. businesses and affiliated persons that make any offer, payment, gift or promise to a foreign official in order to influence obtaining or retaining business
- Can apply to funds and advisers when raising capital or making portfolio investments:
  - Applies to solicitation of investments from sovereign wealth funds or foreign pension plans
  - Potential portfolio investments should be investigated for possible violations
    - Both foreign companies and U.S. companies doing business overseas
    - Foreign state-owned companies or privatizations

Broker-dealer Activity

- Rule 15(a) of the Exchange Act requires persons effecting transactions in securities for the accounts of others to register as broker-dealers
- SEC has indicated that activities of fund managers, employees and agents involved in marketing the fund or selling portfolio investments may require registration, particularly where the associated persons:
  - Actively solicit investors
  - Receives transaction based compensation
- Rule 3a4-1 provides a safe harbor from broker-dealer registration for associated persons of a private fund, where:
  - No commission or performance based compensation is received
  - The person performs other duties on behalf of the fund
  - The person participates in only one offering in any 12-month period
  - Activities are restricted to preparing written disclosure and responding to investor inquiries

Pay-to-Play

- Rule 206(4)-5 of the Investment Advisers Act prohibits investment advisers and "covered associates" from making political contributions or gifts to government officials or candidates for government offices that can direct government plan business
  - "Covered associates" includes managers, executives and marketing personnel and PACs controlled by the adviser
  - Applies to government plan fund investors as well as direct clients
  - Covers coordinating or soliciting contributions from others on behalf of officials or political parties
  - *De minimis* exemption for contributions by covered associates of the adviser:
    - $350 per official per election for whom the covered associate is entitled to vote
    - $150 per official per election for whom the covered associate is ***not*** entitled to vote
  - Two year ban on government business if violated
  - Advisers cannot engage placement agents or municipal advisers unless they are subject to "pay-to-play" rules of FINRA or MSRB
- Pay-to-play rule overlaps with many state lobbying laws

Exchange Act Reporting

Applicable to private funds trading marketable securities

- Schedule 13D
  - Section 13(d) of the Exchange Act requires reporting by any person with beneficial ownership of 5% or more of any class of voting equity securities of publicly traded companies
  - Disclosures include the amount and number of securities acquired, source of funds and intentions with respect to control
    - Control evidenced by activist activities such as seeking a board seat, influencing change in management or engaging in proxy contests
- Schedule 13F
  - Section 13(f)(1) of the Exchange Act requires private fund managers to file reports when publicly traded securities under management exceed $100 million
- Schedule 13G
  - Schedule 13(g) of the Exchange Act allows for short-form reporting by "passive investors" that acquire over 5% but not more than 20% of a class of voting equity securities of publicly traded companies
- Form 13H
  - Rule 13h-1 under the Exchange Act establishes reporting requirements for high volume or high frequency traders
- Section 16
  - Section 16(b) of the Exchange Act prohibits insider "short swing" transactions, i.e., purchases and sales (or sales and purchases) of voting equity securities of publicly traded companies within any 6 month period
  - Section 16(a) requires ownership and transaction reporting (Forms 3, 4 and 5) by persons owning 10% of voting equity securities of a publicly traded company
  - Performance fees of advisers may result in adviser being deemed a beneficial owner of securities held by a fund

New Issues

Applicable to private funds trading marketable securities

- Regulation M under the Securities Act imposes restrictions on purchasing shares in an IPO
  - Prohibits purchasing shares in an IPO if engaged in short selling within 5 business days before pricing
  - No tie-in or laddering – cannot condition allocation of IPO shares on aftermarket purchases
- FINRA Rule 5130 prohibits broker-dealers from selling IPO shares to favored clients
  - "Restricted persons" include portfolio managers of private funds
  - *De minimis* exception for funds where restricted persons hold less than 10%
- FINRA Rule 5131 prohibits spinning and quid pro quo allocations
  - *Spinning*: allocating new issue shares to an account (including any private fund) in which a beneficial interest is held by an executive officer or director of a public company or certain non-public companies in expectation of future business
  - *Quid pro quo allocations:* allocating new issue shares in return for kickbacks
  - *De minimis* exception for funds where such officers and directors hold less than 25%
- Broker-dealers may seek certifications from private funds and advisers for purposes of complying with the new issue rules

Exchange Act Registration

- Section 12(g) of the Exchange Act requires registration of securities of U.S. companies with:
  - more than $10 million of total assets, and
  - a class of equity securities held of record by:
    - 2,000 persons or
    - 500 persons who are not accredited investors
- Registration triggers periodic reporting to the SEC of operating and financial information
- Avoiding Exchange Act registration is typically *not* an issue for even large private funds
  - By definition, 3(c)(1) funds cannot have more than 100 beneficial owners
  - Unlikely that 3(c)(7) funds ever would approach the record holder threshold

DuaneMorris

Further Information

Steven J. Gray, Partner, Chicago
sjgray@duanemorris.com
+1 (312) 499-0112

Federal Regulations Affecting Private Funds

Steven J. Gray

March 2016