

Investment Management and Hedge Funds: What's Happening Now?

Regulatory Roundtable Discussion

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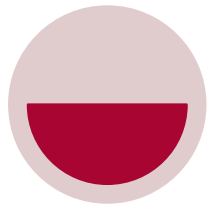
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Attorneys at Law

September 26, 2017 | New York, NY

Presentation Overview

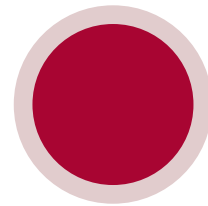
- ▶ New Form ADV
- ▶ State Cyber-Security Regulations
- ▶ FINRA Licensing Exam Requirements
- ▶ Chief Compliance Officer Obligations
- ▶ SEC Enforcement Actions and State Investigations
- ▶ Insider Trading Enforcement Actions
- ▶ Cryptocurrencies – DAO White Paper
- ▶ Questions and Answers

New Form ADV



Significant Changes

- State Issues for Mid-Sized Advisers
- Item 1.J: Payment of CCO
- Item 5.C: Regulatory Assets Under Management
- Item 5.D: Number and Type of Clients
- Item 5.I: Wrap Fee Programs
- Item 5.K: Separately Managed Account Clients



- Item 7.A: Affiliations
- Item 7.B: Private Fund Reporting
- Item 8.H: Compensation for Client Referrals
- Item 8.I: Receipt of Compensation for Client Referrals
- Schedule R: Umbrella Registration
- Effective October 1, 2017

State Cyber-Security Regulations: Colorado

Applicable To:

- Investment advisers and broker-dealers.

Requirements:

- An annual risk assessment of cyber-security practices and establishing a written plan for protecting sensitive data.

Effective Date

- July 15, 2017

State Cyber-Security Regulations: New York

Applicable To:

- All institutions authorized by New York's Department of Financial Services to operate in the state.

Requirements:

- A periodic risk assessment;
- A cyber-security program tailored to its assessed risks;
- Written policies and procedures approved by senior management;
- Designation of a "Chief Information Security Officer;"
- Employment of cyber-security personnel who undergo ongoing training;
- Implementation of risk-based controls;
- Annual certification by the Chairman of the Board;
- Implementation of an incident response plan; and
- Identification of relevant vendors.

Effective Date

- August 28, 2017 for most provisions, as late as 2019 for others.

FINRA Licensing Requirements

- ▶ Overview of Changes:
 - Adopts amendments of NASD and NYSE rules relating to qualification and registration to the FINRA Handbook.
 - Restructures current representative-level qualification examinations.
 - Creates a general knowledge and a specialized knowledge examination.
 - Amends Continuing Education requirements.

CCO Obligations

- ▶ **Craig Scott Capital**: No obligation for CCO to become “self-sacrificing whistle blower”
 - A client filed a claim against ***Craig Scott Capital*** alleging a number of fraudulent activities conducted by the firm. CCO reported various potentially fraudulent reports to the firm’s senior management but did not report it to FINRA. An arbitrator found no laws were violated by keeping the information within the firm.

- ▶ **Strategic Consulting Advisors, LLC**: CCOs are obligated to verify information disclosed to SEC
 - A compliance consulting firm hired as CCO for an investment adviser received an email from the adviser’s CIO estimating the adviser’s AUM. The CCO then submitted the data on the adviser’s form ADV without taking steps to verify the information. CCO was ordered to pay \$30,000 in civil penalties and was suspended from certain activities for 12 months.

SEC Enforcement Actions and State Investigations

Failure to Disclose Fees

- **SEC v. Momentum Investment Partners LLC** - An investment adviser failed to disclose material conflicts of interests involved with moving clients' assets into newly created mutual funds, collecting higher advisory fees, while providing no additional services.
- The adviser must pay \$125,000 in fines and the CEO will be fined \$40,000. Both must return \$68,676 in disgorgement and pre-judgment penalties.

Broker-Dealer "Kickbacks"

- Massachusetts launched a sweep of broker-dealer sales practices to investigate whether brokers are routing stock order to certain exchanges that offer kickbacks in the form of "rebates," instead of seeking best execution.
- Inquiries have been sent to several large broker-dealers.

Insider Trading Enforcement

2016 Supreme Court case, Salman v. United States, clarified the waters muddied by the 2nd Circuit decision in United States v. Newman. Newman held that a gift of material non-public information for trading purposes among family and friends did not run afoul of insider trading laws. The Salman Court found that “a personal benefit includes the benefit one would obtain from simply making a gift of confidential information to a trading relative.”



August 2017, the SEC brought its largest insider trading case since 2015 using its new data analysis tools, despite the traders' attempts to hide the insider trading discussions with encrypted, self-destructing messaging software, in SEC v. Rivas. Because Salman left certain aspects of the Newman holding unchanged, questions still linger with respect to whether a benefit is necessary for information shared with acquaintances or whether the trader must know the tip came from an insider.

Cryptocurrencies: The SEC's Report of Investigation

- ▶ The DAO (Decentralized Autonomous Organization), is one of many virtual organizations issuing a cryptocurrency, and sold 1.15 billion “DAO Tokens” between April 20, 2016 and May 28, 2016, totaling approximately \$150 million.
- ▶ DAO Tokens granted the DAO Tokenholder certain voting and ownership rights, would earn the DAO a profit on certain “projects” and provided DAO Tokenholders with a return on investment.
- ▶ Anyone was eligible to purchase DAO Tokens, and there were no limitations on the number of DAO Tokens offered for sale, the number of purchasers, or the level of sophistication of such purchasers.
- ▶ DAO Tokenholders could redeem their DAO Tokens for Ether (a virtual currency) through a multi-step process that took approximately 46 days.

Cryptocurrencies: The SEC's Report of Investigation (continued)

- ▶ The SEC analyzed the DAO Tokens under the Howey test and found that:
 - Because investors in the DAO use Ether to make their investments, and DAO Tokens were received in exchange for Ether, the investment is a contribution of value that can create an investment contract;
 - Slock.it, the co-founders of the DAO, and its curators were essential to the enterprise;
 - The DAO constitutes an “issuer” under the Securities Act of 1933;
 - DAO Tokens constitute a security under the Securities Act of 1933 and the Securities Exchange Act of 1934; and
 - Any system meeting the definition of an “exchange” under the Securities Exchange Act of 1934 must register as such or operate pursuant to an exemption.
 - Additionally, the SEC noted that “[t]he automation of certain functions through ...technology, “smart contracts,” or computer code, does not remove conduct from the purview of the U.S. federal securities laws.”

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- ▶ Concentrates his practice in securities law, particularly in representing investment management companies and other clients on matters arising under the Investment Company Act of 1940 and the related Investment Advisers Act of 1940
- ▶ Represents many hedge funds and other alternative investment funds in fund formation and investment and compliance matters, including compliance audits and preparation work
- ▶ Writes and speaks frequently on issues involving investment management, health care and other matters. Mr. Nowak is the author of five books on hedge funds.



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- ▶ Focuses her practice on entities regulated under the Investment Company Act of 1940 and the Investment Advisers Act of 1940.
- ▶ Assists clients with the registration of investment companies and investment advisers, as well as with SEC investigations.
- ▶ Has advised various hedge funds and other alternative investment funds in fund formation and compliance matters.



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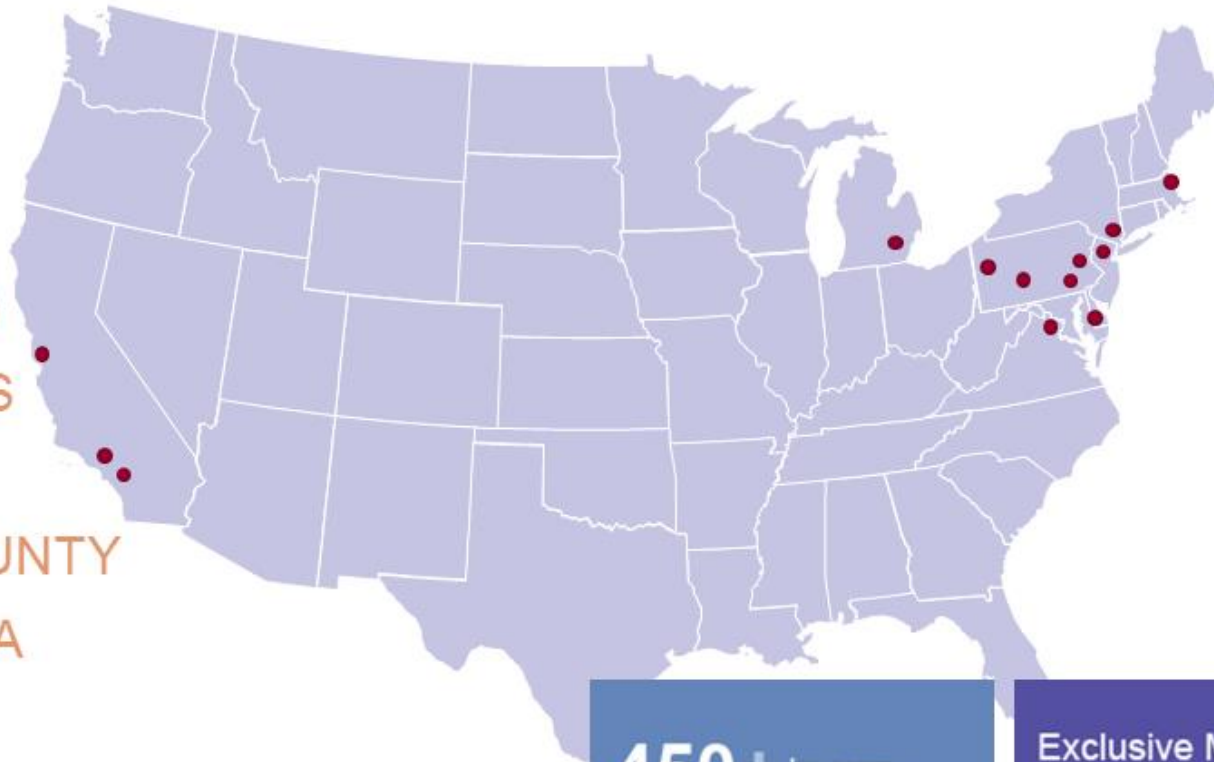
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Questions & Answers