

# Compliance Update

## October 2013

### **Private Funds- General Solicitation**

- General Solicitation Allowed in Certain Private Offerings. New Rule 506(c) allows the use of general solicitation in the sale of private funds for offerings currently relying on Rule 506 of Regulation D, so long as all investors are “accredited investors” and the issuer takes reasonable steps to verify investors’ status as accredited investors.
  - Existing Rule Unchanged. The existing Rule 506 (now called Rule 506(b)) for offerings that do not use general solicitation has not been amended or modified.
  - General Solicitation Not Allowed for Offerings by CFTC Regulated Entities. Fund sponsors that are CPOs or CTAs continue to be prohibited from using general solicitation or general advertising in these offerings, unless and until the CFTC adopts conforming rules.
- **Practical considerations:**
- Effective Date. Issuers (advisers) may begin publicly marketing private funds starting September 23, 2013.
  - Procedural Requirements. An issuer must take **reasonable** steps to verify that an investor is an accredited investor even in circumstances in which the status of an investor as an accredited investor is readily apparent from the circumstances of an offering, such as when an offering has a high minimum investment.
  - Investor Verification Considerations. The determination of what are considered reasonable steps to verify investor status is an objective determination by an issuer based on facts and circumstances. To provide guidance to issuers, the SEC has provided a (1) non-exclusive list of factors that issuers could consider when making reasonableness determinations, and (2) list of specified, non-exclusive methods for verifying that an investor who is a natural person is an accredited investor.
  - Simply Checking a Box Is Not Acceptable. Simply getting an investor to check a box indicating that they are accredited is not sufficient in the case of an offering that is widely advertised or solicited (*i.e.*, Rule 506(c) offering).
  - New Rule Unavailable if “Bad Actor” Connected with Issuer. Rule 506(c) is unavailable to an issuer if, after the effective date of the rule, the issuer or certain persons related to the issuer (*e.g.*, investment manager) have been convicted of certain felonies or misdemeanors or have been the subject of certain other disqualifying events.
  - Update Form D. Issuers conducting Rule 506(c) offerings must indicate that they are relying on the Rule 506(c) exemption by marking the new check box in Item 6 of Form D.

### **Private Funds - Proposed Rule Mandates Legends and Requires Filing of Marketing Materials**

- Filing Requirement for Marketing Materials Used in 506(c) Offerings. Proposed Rule 510T will require issuers on a temporary basis to submit any written general solicitation materials used in their Rule 506(c) offerings to the SEC no later than the date of the first use of these materials. The SEC is seeking public comment on this proposed rule.
- Legends Required on All Marketing Materials. Proposed Rule 509 will require all issuers to include legends as specified by the SEC on all written general solicitation materials.
- Issuer Disqualified if Fails to Comply with Rule 501T or Rule 509. The SEC has proposed to disqualify an issuer from relying on Rule 506 for future offerings if such issuer, or any

predecessor or affiliate of the issuer, has been subject to any order, judgment or court decree enjoining such person for failure to comply with proposed Rule 510T or Rule 509.

➤ **Practical considerations:**

- Create a Filing Procedure. If Rule 510T is adopted, firms will need to create a process to ensure that marketing materials are filed with the SEC prior to their first use.
- Review Marketing Materials for 506(c) Offerings. If Rule 509 is adopted, firms will need to create a review process for 506(c) marketing materials to ensure that the SEC mandated language is prominently disclosed.

**Identity Theft Red Flag Rule (Reg S-ID)**

- Certain SEC and CFTC Entities Required to Implement an Identity Theft Program. The SEC and CFTC's new identity theft red flag rules require SEC and CFTC regulated "financial institutions" and "creditors" that offer or maintain "covered accounts" to establish a written identity theft program that includes policies and procedures designed to: (1) identify relevant red flags, (2) detect red flags, (3) respond appropriately to any red flags detected to prevent and mitigate identity theft, and (4) periodically update the program to reflect changes in risks to customers and to the safety of the firm.

➤ **Practical considerations:**

- Compliance Date. Investment advisers subject to the new rule must have adopted policies and procedures theft by November 20, 2013.
- Review Business Practices to Determine if Firm Falls within the Definition of "Financial Institution" or "Creditor". For example, an investment adviser may be deemed a "financial institution" if: (1) it is permitted to direct transfers or payments from accounts belonging to individuals to third parties upon the individual's instructions, (2) it acts as an agent on behalf of clients that are individuals, or (3) it manages private funds in which an individual invests money and the adviser has authority, under an arrangement with the fund or the individual, to direct such individual's investment proceeds (such as redemptions, distributions or dividends) to third parties according to the individual's instructions.
- Assess Whether "Covered Accounts" Are Offered or Maintained. Periodically assess whether "covered accounts" are offered or maintained. "Covered accounts" include: (1) accounts offered or maintained for personal, family or household purposes that allow multiple payments or transactions, and (2) any other account for which there is a reasonably foreseeable risk to customers or to the safety and soundness of the firm from identity theft, including financial, operational, compliance, reputation or litigation risks. Examples of "covered accounts" include margin accounts and accounts maintained by a mutual fund (or its agent) that permit wire transfers or other payments to third parties.
- Create Policies and Procedures. Develop and implement a written identity theft prevention program.
- Board and Senior Management Involvement Required. Take steps to ensure that the program is implemented effectively by involving the firm's board of directors or a board committee and a designated senior management employee (usually CCO) in the oversight, development, implementation and administration of the program. The initial program must be approved by the board or board committee, or if the firm does not have a board, by a designated senior management employee.
- Training. Train staff on the program's requirements as necessary.
- Oversee Service Providers. Take steps to exercise appropriate and effective oversight of service provider arrangements.
- No Action Necessary for Firms That Have Existing Policies and Procedures Addressing the

FTC's Identity Theft Rules. The new rules are substantially similar to the FTC's existing identity theft red flag rules.

### **Business Continuity Plans**

- SEC Issues National Exam Program Risk Alert. On August 27, 2013, the SEC issued a risk alert on investment advisers' business continuity and disaster recovery planning. The alert was the result of reviews of responses to Hurricane Sandy. The alert is intended to encourage investment advisers to review their business continuity plans so as to improve their responses to significant large-scale events.
- **Practical considerations:**
  - Preparation for Widespread Disruption. Advisers should enhance their programs to better address widespread events, such as making provisions for key personnel to work from home or other remote locations.
  - Planning for Alternative Locations. Advisers should consider establishing back-up locations that are not affected by the same power and utility outages as their main office.
  - Preparedness of Key Vendors. Advisers should consider the IT infrastructure of key service providers, especially if a service provider is located in the same geographic area, and consider having multiple back-up servers. Additionally, advisers should consider how to operate when the adviser's or service provider's facilities are affected by weather-related events, such as flooding.
  - Telecommunications Services and Technology Considerations. Advisers should consider having alternate internet service providers available or obtain guaranteed redundancy from their provider. Advisers should consider diversifying their data/telecommunication connectivity. Advisers should explore using off-site or cloud computing for maintaining their back-up files rather than relying on back-ups maintained at their primary office location.
  - Communication Plans. Advisers should have a plan for how to contact and deploy employees and who will be responsible for executing various elements of the plan.
  - Reviewing and Testing. Advisers should consider testing all critical systems under their BCP rather than conducting only limited tests so as to identify critical weaknesses in advance of an actual disruption.
  - SEC Risk Alert. The complete risk alert can be found here:  
<http://www.sec.gov/about/offices/ocie/business-continuity-plans-risk-alert.pdf>

### **Form 13F Filers- New Submission Requirements**

- New Online Form 13F. The SEC's new online form to be used for all 13F filings, including amendments that need to be made for prior quarters, requires that the Information Table be converted to XML format.
- **Practical considerations:**
  - Effective Date. April 29, 2013.
  - Submission Method Changed. Form 13Fs must now be filed using the online form that is available on the EDGAR Filing Website and construct their Information Table According to EDGAR XML Technical Specification. Filers can choose to construct their entire Form 13F filing according to the EDGAR XML Technical Specification.
  - Form and Instructions Have Not Changed. Form 13F and its instructions have not been amended. Filers should continue to answer each question as they have in the past.
  - Conversion to XML Format Can Be Challenging. Firms can choose to construct only the Information Table in the XML format or to construct their entire Form 13F filing in the XML format. Download the EDGAR Form 13F Technical Specification Manual at

<http://www.sec.gov/info/edgar/specifications/form13fxmltechspec.htm> for the schema that is needed to import into Excel (i.e., save the Information Table schema as an XML document in Word and then import into Excel) or use third party vendors to make their Form 13F filings in the XML format.

### **CTA/CPO Regulation**

- New Rules Expand Entities That Are Required to Register as CTA or CPO. Investment advisers that provide advice regarding commodity interests may be required to register with the Commodity Futures Trading Commission (the “CFTC”) as a Commodity Trading Adviser (“CTA”) and/or a Commodity Pool Operator (“CPO”). Examples of commodity interests include:
  - Futures contracts, including, among other things, contracts based on:
    - physical commodities, interest rates, currency, events; and
    - securities, including contracts based on broad-based securities indices, on a “narrow-based security index” or a single security, and on government securities
  - Options on any futures contract
  - Swaps, including, among other things:
    - swaps based on physical commodities, interest rates, events;
    - swaps based on broad-based securities indices and government securities;
    - currency swaps and forwards;
    - options on commodities; and
    - mixed swaps based on one or more of the foregoing components and one or more components of a swap based on a “narrow-based security index” or a single security
  - Retail forex transactions
  - Leverage contracts
- **Practical considerations:**
  - Definitions Have Changed Requiring Firms to Analyze Whether Exemptions Are Still Applicable. Due to changes in available exemptions and the addition of swaps to the list of commodities interests subject to regulation by the CFTC, investment advisers that previously qualified under an exclusion or exemption from the definition of a CTA or CPO may now be subject to regulation by the CFTC.
  - Periodic Review of Trading Activities Required When Claiming an Exemption From Registration. Advisers should review their trading activities to confirm they continue to fall within available exemptions.
  - Annual Notice Filing Required When Claiming an Exemption. Advisers claiming an exclusion or exemption from registration may need to file annual notices with the regulator to reaffirm the applicable notice of exclusion or exemption. Failure to file the notice may have serious consequences.
  - Contact the NFA with Questions. The National Futures Association’s Information Center is available to respond to questions at 800-621-3570.

### **Social Media**

- LinkedIn Features Should Be Reviewed Before Use. LinkedIn is one of the most popular choices for investment advisers and their employees who use social media for business purposes and/or professional networking. There are features on LinkedIn that advisers should examine carefully before using. These features include:
  - **Recommendations** – this feature allows users to post recommendations on someone’s

- profile either by the user requesting a recommendation or someone in the user's network providing a recommendation without the user asking. Recommendations establish trust and creditability and will be viewed by a regulator to be a testimonial.
- **Endorsements** – this latest feature opens up another issue for advisers with LinkedIn profiles given that advisers are prohibited from using client testimonials. Anyone can visit an adviser's LinkedIn profile and endorse specific skills and expertise. This feature can be disabled.
  - **Books and Records Rules Apply to Social Media.** Statements made by the firm, or associated personnel, to the public that relate to investment management or the firm's activities on social media, on a website, and otherwise, will be subject to the books and records rules. Several social media sites allow users to e-mail, chat or otherwise communicate with other users.
- **Practical considerations:**
- **Compliance with Federal Securities Law Is Required.** Investment advisers using social media must comply with all applicable federal securities laws (including antifraud, compliance, and recordkeeping provisions).
  - **Analyze Personnel Use of Social Media to Mitigate Regulatory Risk.** Even if an investment adviser does not use social media in its official capacity, employees' personal use of social media may subject the firm to regulatory risk.
  - **Adopt Policies and Procedures.** Although no official rule has been published, investment advisers should adopt social media policies and procedures relevant to their social media participation.
  - **Review SEC Guidance.** In developing policies, investment advisers should consider this risk from employee use of social media even if official firm policy prohibits social media use. For guidance on the use of social media, review <http://www.sec.gov/about/offices/ocie/riskalert-socialmedia.pdf>.
  - **Adopt Procedures for Personnel Use of LinkedIn Features.** Consider adopting procedures to ask or require employees to hide "Recommendations" and disable the "Endorsements" feature on their LinkedIn profile.
  - **Train Personnel on Proper Use of Social Media.** Investment advisers should have a robust compliance program built around training associated personnel on the use of social media and also have systems in place to capture and retain communications made with the public.

For your information, please note that the SEC announced the schedule for the remaining 2013 regional compliance outreach seminars for investment advisers and investment company senior officers to be held in Chicago, New York, Atlanta and San Francisco.  
(<http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539720572#.UfrBym15FI0>).

This is only a brief summary of some of the regulatory changes and should not be relied upon for making decisions for your firm. For further clarification on how these changes affect you or for assistance in complying, please contact us.