Private Equity Regulatory Update

September 30, 2019

Rules and Regulations

- SEC Issues Guidance Regarding Proxy Voting Responsibilities of Investment Advisers
- FDIC and OCC Approve Final Amendments to Volcker Rule Regulations
- SEC Expands “Testing the Waters” Communications

Industry Update

- OCIE Issues Risk Alert Regarding Principal and Agency Cross Trading Compliance Issues

Litigation

- Second Circuit Concludes Investment Company Act Creates an Implied Private Right of Action
- Broker-Dealer Settles with SEC for Failure to Supervise Trader Involved in Premium Point Fund Fraud

Rules and Regulations

SEC Issues Guidance Regarding Proxy Voting Responsibilities of Investment Advisers

On August 21, 2019, the Securities and Exchange Commission (the “**SEC**”) issued guidance to assist investment advisers in fulfilling their proxy voting responsibilities (the “**Guidance**”) and an interpretation that proxy voting advice provided by proxy advisory firms generally constitutes a “solicitation” subject to the federal proxy rules (the “**Interpretation**”).

The Guidance:

- May disappoint some companies and investors by not stating generally that an investment adviser with voting authority need not vote in every instance;
- Articulated significant compliance and due diligence burdens that investment advisers will need to consider if they have authority to vote proxies on behalf of their clients, particularly if they utilize proxy advisory firms;
- Will generally require investment advisers with voting authority to review their policies and procedures in light of the positions set forth in the Guidance; and
- May cause investment advisers to consider whether they want to continue to have responsibility for voting proxies for clients or whether they would prefer to restructure their arrangements with clients to eliminate such responsibility or reduce their regulatory burden in this regard.

The Interpretation:

- Reiterated the SEC’s long-held view that a proxy advisory firm’s voting recommendations are proxy solicitations for purpose of the SEC’s proxy solicitation rules; and
- Confirmed that, as such, a proxy advisory firm’s voting recommendations are subject to the proxy solicitation rules’ anti-fraud provisions

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Davis Polk has published a client memorandum discussing the issuance of Guidance and the Interpretation, including key takeaways from the Guidance.

- **See a copy of the Client Memorandum**

FDIC and OCC Approve Final Amendments to Volcker Rule Regulations

The Federal Deposit Insurance Corporation (the "**FDIC**") and the Office of the Comptroller of the Currency (the "**OCC**") approved final amendments to the original Volcker Rule regulations (the "**2019 Final Amendments**"), which were first adopted in December 2013. The Federal Reserve, SEC and Commodity Futures Trading Commission are expected to approve these same amendments in the coming days. The effective date of the 2019 Final Amendments is January 1, 2020, with compliance required by January 1, 2021.

Davis Polk has published a visual memorandum regarding the 2019 Final Amendments. The visual memorandum first discusses the background to the 2019 Final Amendments and the key changes contained in the 2019 Final Amendments. The visual memorandum also provides updated proprietary trading flowcharts, which graphically summarize the proprietary trading portion of the Volcker Rule regulations, as amended by the 2019 Final Amendments.

- **See a copy of the Visual Memorandum**

SEC Expands "Testing the Waters" Communications

On September 26, 2019, the SEC announced a welcome, broad expansion of "testing the waters" flexibility for all companies. Under new Rule 163B, all companies, and persons authorized to act on their behalf (such as underwriters), will be able to gauge market interest in a possible offering with qualified institutional buyers and institutional accredited investors prior to or after the filing of a registration statement. The new rule is welcome relief for all non-emerging growth companies and for companies without a registration statement on file.

Davis Polk has published a Client Memorandum discussing the new rule, including its applicability to registered investment companies and business development companies.

- **See a copy of the Rule**
- **See a copy of the Client Memorandum**

Industry Update

OCIE Issues Risk Alert Regarding Principal and Agency Cross Trading Compliance Issues

On September 4, 2019, the Office of Compliance Inspections and Examinations ("**OCIE**") of the SEC issued a risk alert (the "**Risk Alert**") to provide investment advisers with information regarding common deficiencies identified in recent examinations related to principal trading and agency cross transactions under Section 206(3) of the Investment Advisers Act of 1940 (the "**Advisers Act**") and Rule 206(3)-2 thereunder.

Section 206(3) makes it unlawful for any investment adviser acting as a principal for his or her own account to knowingly "sell any security to or purchase any security from a client" (a "**principal trade**") without disclosing to such client in writing before the completion of such transaction the capacity in which the adviser is acting and obtaining the client's consent to such transaction. Additionally, advisers must obtain client consent for principal trades on a transaction-by-transaction basis—blanket disclosure and consent are not permitted. Section 206(3) also prohibits an adviser from knowingly effecting a sale or

purchase of a security for a client where the adviser is, directly or indirectly, acting as a broker for a person other than the advisory client (an "**agency cross transaction**") without disclosing its capacity to the client and obtaining client consent. Rule 206(3)-2 provides that transaction-by-transaction disclosure and consent is not required for agency cross transactions, and blanket consent can be obtained if, among other things: (1) the client has executed a written consent prospectively authorizing agency cross transactions after receiving full written disclosure of the conflicts involved (and other information described in the rule); (2) the adviser provides a written confirmation to the client at or before the completion of each transaction disclosing, among other things, the source and amount of any remuneration received by the adviser; (3) the adviser provides a written disclosure, including a summary of all agency cross transactions during the period, on at least an annual basis; and (4) the written disclosure documents and confirmations conspicuously disclose that consent may be revoked at any time.

According to the Risk Alert, OCIE staff identified four common investment adviser compliance issues related to principal and agency cross trading under Section 206(3) and Rule 206(3)-2 during examinations over the past three years:

- OCIE *staff observed advisers that did not follow the specific requirements of Section 206(3).* For example, some advisers did not recognize that they were effecting principal trades subject to Section 206(3). Other advisers recognized that they were engaging in principal trades, but failed to obtain appropriate client consents or failed to provide sufficient disclosure regarding potential conflicts of interest. OCIE staff also observed advisers that had obtained consent *after* the completion of the transaction.
- OCIE *staff observed advisers that engaged in transactions involving pooled investment vehicle clients where the advisers involved did not follow the requirements of Section 206(3)*. OCIE staff observed advisers that failed to recognize that their significant ownership interest in pooled investment vehicles would cause the transaction to be subject to Section 206(3) and then failed to obtain effective consent from pooled investment vehicle clients prior to completing the transaction.
- OCIE *staff observed advisers' practices that gave rise to compliance issues in connection with agency cross transactions*. OCIE staff observed advisers engaging in agency cross transactions after disclosing to clients that they would not do so, or effecting such transactions relying on Rule 206(3)-2 without producing any documentation that they had complied with the consent, confirmation or disclosure requirements of the rule.
- OCIE *staff observed advisers that did not have policies and procedures relating to Section 206(3) (or failed to follow such policies) even though the advisers engaged in principal trades and agency cross transactions*.

The OCIE staff encourages advisers to review their written policies and procedures and their implementation to ensure that they are compliant with the principal trading and agency cross transaction provisions of the Advisers Act and the rules thereunder.

- **See a copy of the Risk Alert**

Litigation

Second Circuit Concludes Investment Company Act Creates an Implied Private Right of Action

On August 5, 2019, the United States Court of Appeals for the Second Circuit ruled that section 47(b) of the Investment Company Act creates an implied private right of action allowing parties to sue for rescission of a contract that allegedly violates the Investment Company Act. The Second Circuit's decision creates a circuit split, raising the prospect of Supreme Court review, as the Third Circuit and

several district courts had previously concluded that the Investment Company Act does not create an implied private right of action.

In *Oxford University Bank v. Lansuppe Feeder, Inc.*, a private fund issuer claimed an exemption from registration as an "investment company" under the Investment Company Act, relying on section 3(c)(7), which exempts issuers whose securities are owned exclusively by "qualified purchasers" or "knowledgeable employees." Holders of a class of junior notes of the issuer alleged that the exemption had been violated because certain notes had been resold to non-qualified purchasers.

Section 47(b) of the Investment Company Act provides, that "(1) a contract that is made, or whose performance involves, a violation of [the Investment Company Act] is unenforceable" and that "[t]o the extent that a contract described in paragraph (1) has been performed, a court may not deny rescission at the instance of any party unless such court finds that under the circumstances the denial of rescission would produce a more equitable result . . . ." Plaintiff-intervenors argued that the indenture under which the notes were issued was a contract that violates the Investment Company Act, and sued for rescission of the indenture and their purchases of notes under section 47(b) of the Investment Company Act. The district court concluded that no private right of action exists under section 47(b) because (i) the Investment Company Act provides for SEC enforcement of the provision declaring contracts in violation of the Investment Company Act void; (ii) the Investment Company Act expressly provides for private enforcement under section 36(b), and (iii) there was "no implication of an intent to confer rights" on entities such as the plaintiff.

On appeal, the Second Circuit affirmed the District Court's grant of summary judgment, but on different grounds. The Second Circuit held that the text of section 47(b) stating that "a court may not deny rescission at the instance of any party" presupposes that a party may seek rescission by filing suit, and "is thus effectively equivalent to providing an express cause of action." Similarly, the panel concluded that parties to contracts violating the Investment Company Act are exactly the "class of persons" that section 47(b) aims to protect through the creation of a private right of action, and that both the legislative history and congressional intent behind section 47(b), which was added to the Investment Company Act by a 1980 amendment, supported this interpretation. In reaching its decision, the Second Circuit considered, but ultimately disagreed with, the Third Circuit's contrary decision in *Santomenno ex rel. John Hancock Trust v. John Hancock Life Ins. Co.*, 677 F.3d 178 (3d Cir. 2012), in which the Third Circuit concluded that section 47(b) did *not* create a private right of action.

The Second Circuit nonetheless affirmed the district court's decision to dismiss plaintiff-intervenors' claims on the ground that the plaintiff-intervenors had not demonstrated that the indenture under which the notes were issued was a contract "made, or whose performance involves, a violation" of the Investment Company Act, and that the relief they sought was not rescission, but "a restructuring of its terms to give junior notes a priority status equal to that of senior notes[,]" which is not contemplated by the statute.

One consequence of the Second Circuit's decision—and of the split with the Third Circuit—is that the issue may be more likely to be reviewed by the Supreme Court. The creation of a new implied private right of action also opens the door to additional litigation by parties to contracts subject to the Investment Company Act, and to litigation aimed at increasing the scope of this right of action.

- **See a copy of the Second Circuit Opinion**

Broker-Dealer Settles with SEC for Failure to Supervise Trader Involved in Premium Point Fund Fraud

As reported in our prior updates of **May 2018** and **July 2019**, in 2018 the SEC sued Premium Point Investments, LP ("**Premium Point**") a registered investment adviser, its CEO, a portfolio manager, and a trader, for allegedly inflating the performance of Premium Point's managed fund by, among other things, asking "friendly" brokers to obtain specific marks on bonds held by Premium Point, in exchange for

directing trades to those brokers. In July 2019, a jury found Premium Point's CEO and a trader guilty of securities fraud, wire fraud, conspiracy to commit securities fraud and conspiracy to commit wire fraud. One of the "friendly" brokers involved in the scheme, Frank Dinucci Jr. ("**Dinucci**"), pleaded guilty to several criminal counts including securities fraud.

On August 20, 2019, the SEC brought and settled an enforcement action against Mosaic Capital, LLC, formerly known as AOC Securities, LLC ("**AOC**"), for failing to reasonably supervise Dinucci. The SEC alleged that AOC and its executive officer did not establish policies and procedures reasonably designed to prevent and detect Dinucci's violations. AOC agreed to be censured and to pay a civil money penalty of $250,000. AOC had also withdrawn from registration as a broker dealer as of December 2018.

- **See a copy of the SEC Order**

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