INVESTMENT MANAGEMENT AND PRIVATE FUNDS

- What's Happening Now
- Summer Roundup
- Raising Money in a Pandemic – 506(c)

VIRTUAL ROUNDTABLE
September 30, 2020

GREGORY J. NOWAK, ESQ.
Troutman Pepper Hamilton Sanders, LLP
(215) 421-7288 (M)
Gregory.Nowak@troutman.com

EVAN H. KATZ, ESQ.
Crawford Ventures, Inc.
(212) 904-0909 (O)
Ekatz@crawfordventures.com

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Gregory Nowak is sought after for advice on complex securities law matters, particularly on issues arising out of the Investment Company Act of 1940; the Investment Advisers Act of 1940; federal and state securities laws and regulations; broker dealer, FINRA, CFTC and NFA regulatory matters; and corporate and M&A transactions.

Greg also represents many hedge funds and other alternative investment funds in fund formation and investment and compliance matters, including compliance audits and preparation work. Greg has represented a broad range of investment funds, from funds that use the traditional broad investment charters and invest globally in virtually any financial asset that can be readily traded to specialty niche funds.

Greg writes and speaks frequently on issues involving alternative lending, blockchain, initial coin offerings (ICOs), investment management, health care and other matters and is the author of five books on hedge funds.

Gregory J. Nowak, Esq.

215.981.4893

Gregory.nowak@troutman.com

Philadelphia/New York

Investment Funds

Evan Katz is Managing Director of Crawford Ventures, Inc., a leading Manhattan-based alternative asset investment firm that forms, grows, holds interests in, and raises very substantial investor capital for, compelling hedge funds, private equity funds, and other alternative investment funds.

An honors graduate of The Wharton School of Business and Harvard Law School, Evan has worked on Wall Street since 2003, and is highly regarded as an expert on alternative asset best practices, institutional investors, family offices, and successful large-scale fundraising. In this regard, he has raised very substantial investor capital and commitments for compelling hedge funds, private equity funds, and early stage technology and medical life sciences companies.

Evan is a twice-elected Director on the Hedge Fund Association (HFA) Board of Directors, on which he served from 2014 to 2019. He previously served for two years on the HFA Advisory Board (2012-2014), and also was honored with and received the "Young Leadership Award" at the 2011 Hedge Fund Summit.

Evan H. Katz, Esq.

212.904.0909

Ekatz@crawfordventures.com

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Firm Overview

Troutman Pepper is a national law firm known for its higher commitment to client care. With more than 1,100 attorneys in 23 U.S. offices, the firm partners with clients across every industry sector to help them achieve their business goals. Read more about the firm's litigation, transactional, and regulatory practices at troutman.com.

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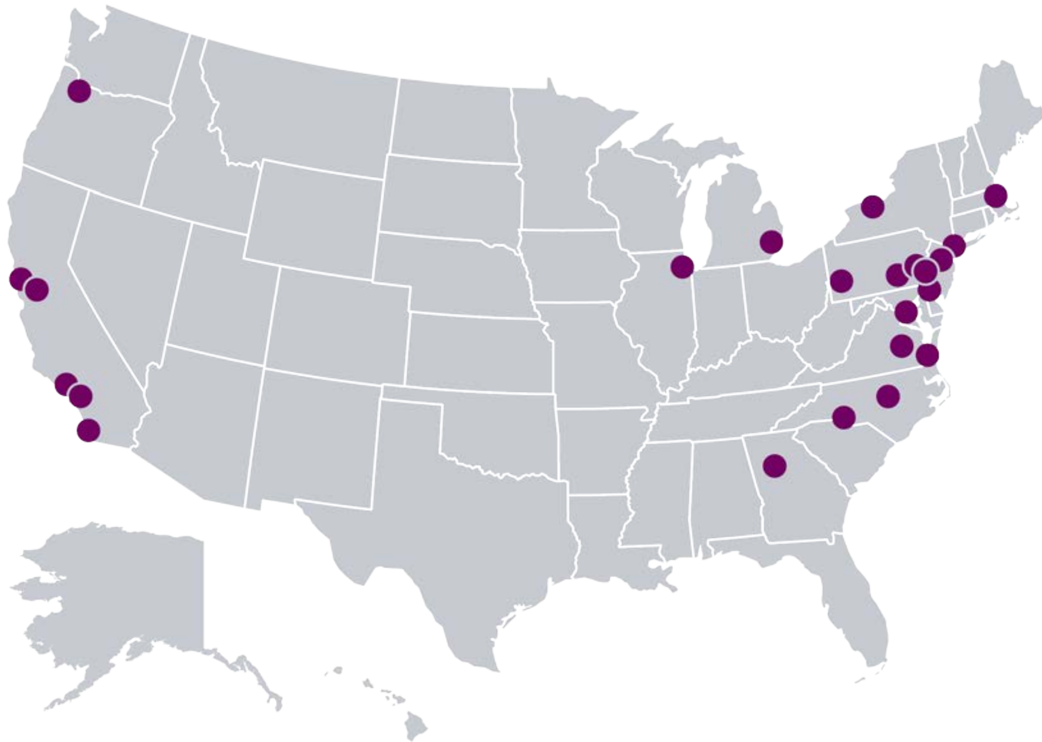

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47th
projected Am Law ranking

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Agenda

- Recent Enforcement Actions by the SEC – Crypto; MCAs; Cross trades
- Sponsoring broker FINRA clarifications
- CFTC Compliance Manual Release and Enforcement Priorities
- Expenses and Disclosure
- Raising Capital in a Pandemic—is 506(c) finally living up to its promise?

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Recent Actions by SEC and FINRA

- Crypto
- MCA
- Adviser Cross Trades
- Sponsoring Broker Issues

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ICO Cases Have Familiar Themes

- Tokens/Coins were determined to be securities by the SEC
- The issuers did not register with the SEC under the 1933 Act or no exemption was available
- They allowed immediate trading in the secondary market
- They provided no disclosure to investors
- Many were “scams”
- How do they differ from “Blank Check SPACs”? Both raise risk capital. The latter are registered offerings that have disclosed, disclosed and disclosed, an the money raised is safeguarded in real custody accounts!

ICOs and MCAs – SEC Actions

ICO	=	Initial Coin Offerings
MCA	=	Merchant Cash Advances
Participation	=	Contractual interest – yes; Security? It depends …
Security	=	Investment Contract = Howey test and Reves test

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SEC v. W. J. Howey, Co., 328 U.S. 293 (1946)

- **Investment of money**
- **In a common enterprise**
- **With the expectation of profit**
- **From the efforts of others**

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ICOs

- **June 19, 2020 -- Emergency complaint against Huizdzak Capital and Shane and Sean Huizdzak, et al.**
  A. Fraudulent raise and misappropriation of money in a fund: misrepresented past performance and assets, provided investors with false financial statements and a forged audit report.
  B. Dollars were dissipated into personal digital asset accounts of two promoters.
- **June 26, 2020 -- Telegram Group –**
  A. Telegram returned more than $1.2 billion to investors and paid a $18.5 million penalty.
  B. “Grams” were unregistered securities.
  C. There was no admission or denial of the allegations, but Telegram did consent to the disgorgement and penalty, and an injunction, and must give notice to the SEC before participating in the issuance of digital assets – for three years.

ICOs (continued)

- **August 13, 2020 – Boon Tech enforcement action**
  - $5MM ICO of "Boon Coins"
  - Sold Boon Coins to more than 1500 investors in U.S. and worldwide to develop and market a platform to connect employers posting jobs with freelancers seeking work.
  - Represented that Boon Coins were using "patent-pending technology" to hedge Boon Coins against the U.S. Dollar – but no technology existed.
  - Remedy -- $5MM disgorgement; $600K prejudgment interest; destroy all Boon Coins; issue requests to all third-party platforms to stop trading
  - Penalty -- Promoter penalized $150,000 and barred from serving as an officer or director of a public company

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ICOs (continued)

- **September 15, 2020 -- Unikrn, Inc.**
  - Unikrn was the operator of an Esports gaming and gambling platform
  - Raised $31MM in its offering of *UnikoinGold* (UKG) tokens
  - SEC held – Unikrn had sold investment contracts and failed to register them
  - Remedy -- Return all money
  - Pay a $6.1 MM penalty representing virtually all of Unikrn's assets
  - SEC Commissioner Hester M. Peirce (the "CryptoMom") dissented and said this action stifled innovation. Where there is no allegation of fraud and just an allegation of failure to comply with registration requirements, a different remedy is appropriate, according to Commissioner Peirce.

MCA Issues

- ***SEC v. CAN Capital, Inc.*** **(SDNY Filed May 4, 2020)**
  - 2014 CAN raised $191MM from investors through the securitization of a revolving pool of MCA's and business loans
  - How CAN treated non-performing MCAs and business loans was key to investors. CAN's "32 day non-performing rules" were central to the case.
  - CAN had granted forbearance to merchants — the grace period was inconsistent with the disclosure.
  - Result, because of the use of the non-disclosed grace periods, the securitization failed to meet certain credit enhancement requirements that were designed to limit investor risk and the Class B investors incurred losses.
  - Injunction consented to by CAN Capital

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MCA Issues (continued)

- ***SEC v. Complete Business Solutions Group, Inc.*** **(d/b/a Par Funding)**

  July 31, 2020

  Allegedly:

  – Used a network of unregistered sale agents and affiliated entities to sell promissory notes to the public while lying to or misleading investors about the Par Funding business, how investors funds would be used, and La Forte's role and criminal history.

  – Violations of 17(a) of the 1933 Act, Section 10b and Rule 10b-5 of the Exchange Act of 1934 and Section 5(a) and 5(c) of the Securities Act.

  – Used Agent funds to raise money and funnel to Par Funding

  – Still working its way through courts.

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Adviser Cross Trade Enforcement Action

- **Palmer Square IA-5586 9/21/20 - Settled Enforcement Action**
  - Palmer Square arranged cross trades among registered and private funds it managed <u>351</u> times between July 2014 and September 2016
  - Purchasing side *always* paid a mark-up
  - Registered funds violated statutory provisions on cross trading without complying with exemptive Rule 17a-7
    - Interposition of a broker did not help - §48
  - Adviser violated Section 206(3) and 206(4) and Rule 206(4)-7 of the Advisers Act
  - Cease and desist, censure and civil penalty of $450,000

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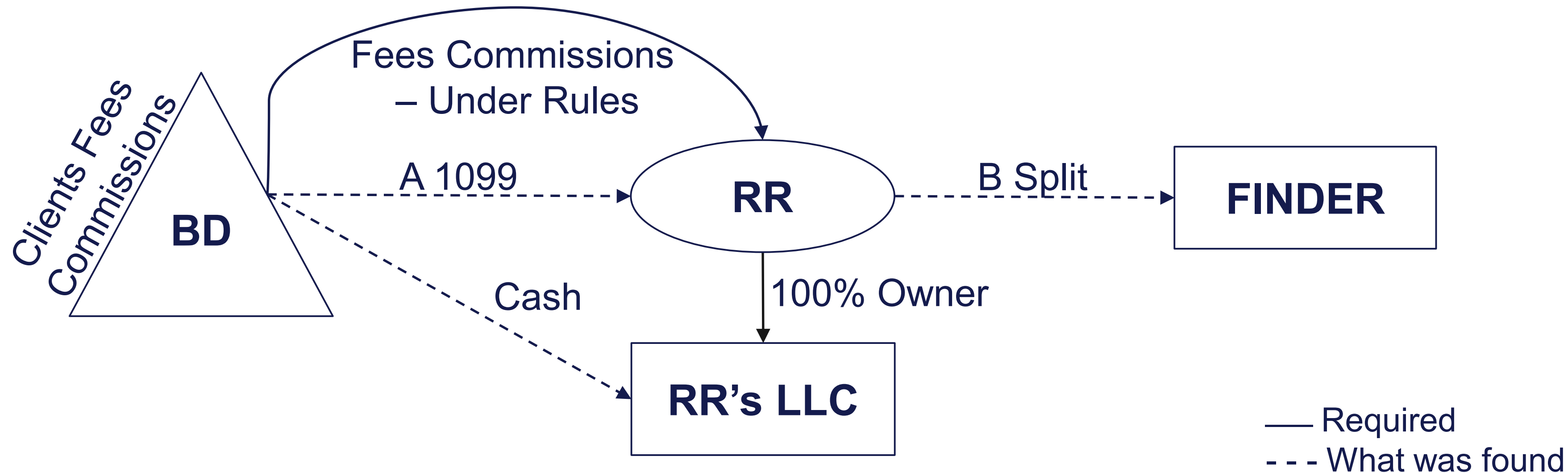
Department of Enforcement vs. Silver Leaf Partners, LLC
FINRA National Adjudicatory Council 6/29/20

- **Found Silver Leaf split commissions with unlicensed persons**



▪ NASD Rule 2420 and FINRA Rule 2010	$50,000 fine
▪ NASD Rule 3010 and FINRA 3110 ▪ Failure to supervise	$50,000 fine and subject to enhanced supervision until a consultant is engaged and implementation of recommendations of consultant is certified
▪ Costs	$19,651

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CFTC Enforcement Manual Release Trends

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CFTC ENFORCEMENT PRIORITIES

- **New Manual issued May 20, 2020**
- **Summary of Types of Prohibited Conduct Subject to Investigation: Conduct prohibited under the CEA and the Regulations includes, among other things:**
  - fraud, including fraudulent solicitation, concealment and misappropriation;
  - false statements to the CFTC;
  - price manipulation;
  - use of a manipulative or deceptive device;
  - misappropriation of material, confidential, non-public information;
  - disruptive trading practices, including disregard of orderly execution during the closing period and spoofing;

CFTC ENFORCEMENT PRIORITIES (continued)

- fraudulent trade allocation;
- trade-practice violations (trading ahead, prearranged trading, bucketing, trading at other than bona-fide prices, wash sales, and position limits);
- false reporting;
- undercapitalization.

Fund Expenses

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SEC's focus on Fund Expenses Continue

- **Rialto Capital Management, IAA Release No. 5558, August 7, 2020**
  - Settled by Rialto without admitting or denying allegations; Rialto did consent to SEC's Order.
  - Findings by SEC – Matter concerned manner in which Rialto allocated certain costs and expenses for third party tasks for two real estate private equity funds—asset-level due diligence, accounting valuations and similar services.
    - From 2012 to 2017 Rialto misallocated to Fund I and Fund II $3MM that should have been allocated to co-investment vehicles
    - Rialto told the LPACs the costs were at or below third-party charges, but they only did a survey in 2012, and not after.
  - Violations of Advisers Act Section 206(2) and 206(4).

SEC's focus on Fund Expenses Continue (continued)

- Violations of Advisers Act Section 206(2) and 206(4).
  - Section 206(2) of the Advisers Act prohibits investment advisers from directly or indirectly engaging "in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." **A violation of Section 206(2) of the Advisers Act may rest on a finding of simple negligence; scienter is not required.** *SEC v. Steadman*, 967 F.2d 636, 643 n.5 (D.C. Cir. 1992) (citing *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194-95) (1963)). As a result of the conduct described above, Rialto willfully violated Section 206(2) of the Advisers Act.

SEC's focus on Fund Expenses Continue (continued)

- Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder make it unlawful for any investment adviser to a pooled investment vehicle to "[m]ake any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle" or to "engage in any act, practice or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle." **A showing of negligence is sufficient to establish a violation of Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder.** *Steadman*, 967 F.2d at 647. As a result of the conduct described above, Rialto willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder.

SEC's focus on Fund Expenses Continue (continued)

- Rialto remediated the funds (i.e., they paid back the $3MM)
- Rialto promised to cease and desist in committing these violations
- Rialto was censured
- Rialto was required to pay a $350,000 fine to the SEC for transfer to the Treasury. No tax deduction for the penalty was allowed.

Raising Capital in a Pandemic

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Raising Capital in a Pandemic

1. **All applicable limitations still apply -- §3(c)(1) and §3(c)(7) of the Investment Company Act of 1940 provide a "definitional barrier" – i.e., except in a 506(c), no "general solicitation" is allowed**
2. **What is a public offering (Section 4(a) of the Securities Act of 1933)**
3. **Have you invoked the safe harbor of Regulation D?**
4. **Who are "friends and family"?**
5. ***SEC v. Ralston Purina*, 346 US 119 (1953) is still the standard**
6. **Using placement agents – same limits under paragraphs 1, 2, 3, 4 and 5, above.**

Raising Capital in a Pandemic (continued)

- **Jobs Act Offering under Rule 506(c) of Regulation D under Section 4(a) of the Securities Act of 1933 and applicable regulations.**
  - Exempts a fund offering from #1, 2, 4 and 5 (prior page).
  - Must file a Form D to invoke it.
  - Can offer to anyone (i.e., advertising is allowed), but can only accept subscriptions from verified "accredited investors“
- **Most Hedge Funds and Private Equity Funds have Performance Fees/Allocations/Back-End Carry or Profit Shares**
  - All investors must be "qualified clients" under Advisers Act Rule 205-3 so they already meet the $$ tests—it becomes a question of verification.
- **Blast emails allowed under a 506(c).**
  - **Leap-frog gatekeepers – educating the consumer.**

Thank You!

Gregory J. Nowak
215.981.4893
Gregory.nowak@troutman.com

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