Private Equity Regulatory Update

January 30, 2018

Rules and Regulations

SEC Adopts Amendments to Advisers Act Rules to Reflect Changes Made by FAST Act

On January 5, 2018, the SEC adopted final rules (the "**Final Rules**") amending the definition of "venture capital fund" under Rule 203(l)-1 and the private fund adviser exemption under Rule 203(m)-1 under the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"), to reflect changes made by Title LXXIV, Sections 74001 and 74002 of the Fixing America's Surface Transportation Act of 2015 (the "**FAST Act**"), which amended Sections 203(l) and 203(m) of the Advisers Act. For a detailed discussion of the amendments, please see the **May 25, 2017 Investment Management Regulatory Update**.

The Final Rules (i) amend the definition of "venture capital fund" to include "small business investment companies," as described in Section 203(b)(7) of the Advisers Act (other than an entity that has elected to be regulated or is regulated as a business development company pursuant to Section 54 of the Investment Company Act) and (ii) amend the definition of "assets under management" in the private fund adviser exemption to exclude the assets of "small business investment companies."

The Final Rules will become effective on March 12, 2018.

- **See a copy of the Final Rules**

Industry Update

CFTC Releases Backgrounder on Oversight of and Approach to Virtual Currency Futures Markets

On January 4, 2018, the CFTC issued a **Backgrounder on Oversight of and Approach to Virtual Currency Futures Markets** (the "**Backgrounder**") with an accompanying statement from Chairman J. Christopher Giancarlo. The Backgrounder describes (1) federal and state oversight of and jurisdiction over virtual currencies; (2) the CFTC's approach to virtual currency regulation; (3) the self-certification process generally, as well as specifically the recent self-certification of new contracts for bitcoin futures

products by designated contract markets ("**DCMs**"); (4) the CFTC's "heightened review" for virtual currency contracts; and (5) the constituencies the CFTC believes could be impacted by virtual currency futures.

In 2014, the CFTC declared virtual currencies to be a "commodity" subject to CFTC oversight under the Commodity Exchange Act (the "CEA"). Since then, the CFTC has **taken action** against unregistered bitcoin futures exchanges, **enforced** the laws prohibiting wash trading and prearranged trades on a derivatives platform, issued **proposed guidance** on what is a derivative market and what is a spot market in the virtual currency context, **issued warnings** about valuations and volatility in spot virtual currency markets and **addressed** virtual currency Ponzi schemes.

On December 1, 2017, the Chicago Mercantile Exchange and the CBOE Futures Exchange self-certified new contracts for bitcoin futures products, and the Cantor Exchange self-certified a new contract for bitcoin binary options. In the Backgrounder, the CFTC discusses the self-certification process, including the "heightened review" that the CFTC staff and DCMs have applied in their review of the terms and conditions of virtual currency futures. According to the CFTC, such heightened review includes "extensive visibility and monitoring of markets for virtual currency derivatives and underlying settlement reference rates," including determining that the CFTC has the means to police certain underlying spot markets for fraud and manipulation.

In addition, Commissioner Giancarlo noted that the CFTC's Market Risk Advisory Committee (the "**MRAC**"), will hold a meeting on January 31, 2018 "to consider the process of self-certification of new products and operational rules by DCMs under the CEA and CFTC regulations." The MRAC meeting is scheduled to take place the week after a January 23, 2018 meeting of the CFTC Technology Advisory Committee, which will consider the "related challenges, opportunities, and market developments of virtual currencies."

Litigation

Texas Securities Commissioner Issues Cease and Desist Order Against Cryptocurrency Promoter

On January 4, 2018, the Securities Commissioner of the State of Texas (the "**Commissioner**") issued an emergency cease and desist order (the "**Order**") against BitConnect, an England-based cryptocurrency producer and promoter, for violating securities registration requirements, making materially misleading and deceptive statements and making fraudulent statements. The Commissioner's findings echo the issues and concerns noted in the North American Securities Administrators Association's recent release (the "**NASAA Release**") regarding cryptocurrencies, initial coin offerings ("**ICOs**") and other cryptocurrency-related investment products.

According to the Order, BitConnect, via its website and sales agents, solicits Texas residents for the purpose of investing in the BitConnect Lending Program, a plan which allows potential investors to purchase BitConnect Coins and then lend them out through a dashboard on the BitConnect website. According to the Order, the BitConnect website represents that investors may earn up to 40% interest per month over a specified term, plus an additional rate of interest calculated on a daily basis. BitConnect, according to the Order, encourages sales agents to promote the BitConnect Lending Program through social media, blogs, websites, marketing materials and online advertisements, at times in conjunction with unique referral links that automatically credit a sales agent with the sale. In addition, according to the Order, the BitConnect website and BitConnect sales agents offer Texas residents the opportunity to invest in BitConnect's Staking Program. According to the Commissioner, investors in the program purchase BitConnect Coins, transfer them to the BitConnect online "wallet" and earn interest on all coins held there for more than fifteen days. The BitConnect website, according to the Order, represents that

investors in the program can earn interest of up to 120% per year. Finally, according to the Order, BitConnect planned to hold an ICO on or around January 10, 2018.

According to an SEC public statement supporting the NASAA Release, despite previously being marketed as replacements for traditional currencies, cryptocurrencies lack important traditional currency characteristics, such as sovereign backing, and should be viewed more as investment opportunities. Nonetheless, according to the SEC, many promoters of ICOs and other cryptocurrency market participants are not abiding by state and federal securities laws, and while the SEC and state securities regulators are pursuing violations, there is a significant risk they may not be able to recover lost investments.

According to the Order, BitConnect and its investment programs violated multiple registration requirements in Texas, including failing to register investments in its investment programs, failing to register with the Commissioner as a dealer or agent and recruiting sales agents who are not registered with the Commissioner as dealers or agents. Further, according to the Commissioner, BitConnect's representations that its website does not constitute an offer to buy or sell securities is materially misleading and likely to deceive the public, since its website offers investments in its lending and staking programs and such investments constitute securities. In addition, according to the Order, BitConnect intentionally failed to disclose material facts in connection with its offer of investments in the BitConnect Lending Program and BitConnect Staking Program, including the identity of its principals, its principal place of business and information regarding the development of the business and its finances. In addition, according to the Order, BitConnect misrepresented material facts by representing that the BitConnect Lending Program was a safe and low risk way to earn a high rate of return because BitConnect acknowledges that there are significant risks associated with virtual currencies and its lending program, including legislative and regulatory changes, the irrevocability of transactions in virtual currencies and the inherent volatility of virtual currencies. Also, according to the Order, BitConnect intentionally failed to disclose financial information regarding its staking program and made materially misleading and deceptive statements by presenting investments in its staking program as safe.

In light of the above findings, the Commissioner ordered that BitConnect immediately cease and desist from (i) offering any security in Texas until the security is registered or offered pursuant to an exemption from registration, (ii) acting as a securities dealer in Texas until it is registered or acting pursuant to an exemption from registration, (iii) engaging in any fraud in connection with the offer for sale of any security in Texas and (iv) offering securities in Texas through an offer containing a statement that is materially misleading or otherwise likely to deceive the public. According to the Order, BitConnect may request a hearing within 31 days of the date the Order was served.

- **See a copy of the Order**
- **See a copy of the NASAA Release**
- **See a copy of the SEC's Public Statement**

SEC Charges Investment Adviser, Its President and Its Former Chief Compliance Officer with Violations of the Advisers Act and Safeguards Rule

On December 22, 2017, the SEC issued an order (the "**Order**") instituting and settling administrative and cease-and-desist proceedings against Southwind Associates of NJ Inc., an investment adviser registered with the SEC ("**Southwind**"), Southwind's president (the "**President**") and Southwind's former Chief Compliance Officer (the "**CCO**") for violations under the Advisers Act and Rule 30(a) of Regulation S-P, 17 C.F.R. § 248.30(a) (the "**Safeguards Rule**").

According to the Order, the SEC's Office of Compliance Inspections and Examinations ("**OCIE**") conducted three separate examinations of Southwind in 2003, 2006 and 2013, each time issuing a deficiency letter. In May 2011, Southwind hired a compliance consulting firm (the "**Consultant**") to review

its compliance program, and according to the Order, the Consultant identified 59 separate action items, including items relating to custody, electronic communications, books and records and compliance manual and policies, and assisted Southwind in conducting quarterly reviews to ensure such items were addressed. Nonetheless, according to the Order, Southwind failed to timely implement the majority of the Consultant's recommendations.

According to the Order, despite being aware of the requirements of Rule 206(4)-2 under the Advisers Act (the "**Custody Rule**"), Southwind failed to conduct surprise examinations of those client accounts over which it had custody for every year but one, and Southwind failed to both provide certain of its private fund clients with audited financial statements within the required timeframe and to have an appropriate independent public accountant perform the audits. Further, according to the Order, Southwind failed to establish procedures related to the maintenance and preservation of client records until May 2012, and such procedures failed to be specifically tailored to Southwind's business and electronic storage media recordkeeping until May 2016. In addition, according to the Order, Southwind failed to preserve certain electronic communications and, during the 2013 OCIE examination, the CCO failed to inform OCIE that Southwind had previously determined that it may have had an issue with its preservation of electronic communications; only two months after OCIE's initial request did Southwind state that certain electronic communications could not be retrieved. As such, according to the Order, the CCO failed to ensure Southwind's compliance with certain books and records requirements under the Advisers Act, and the President did not take adequate steps to address this failure, despite being aware of the issue. Further, according to the Order, Southwind failed to timely update its compliance manual to reflect the amendment or adoption of relevant rules under the Advisers Act, including changes to the Custody Rule, and Southwind failed to implement certain written policies and procedures related to the Custody Rule and the maintenance and preservation of electronic records. Finally, according to the Order, the CCO failed to perform an annual review of Southwind's policies and did not ensure that they were adequately and effectively implemented, and the President failed to adequately address these issues despite being aware of them.

According the SEC, all of the violations in the Order were identified by the OCIE in deficiency letters following OCIE examinations or after being highlighted in the Consultant's recommendations. According to the Order:

- Southwind violated Section 206(4) of the Advisers Act and Rule 206(4)-2 thereunder, which require registered investment advisers with custody of client funds or securities to have independent public accountants conduct surprise examinations of those client funds or securities, or to have any private fund clients timely distribute annual audited financial statements to their investors and to have that audit performed by an independent public accountant subject to regular inspection by the Public Company Accounting Oversight Board;
- Southwind violated Section 204(a) of the Advisers Act and Rule 204-2(a)(7) thereunder, which require registered investment advisers to create and maintain originals of all written communications received and sent relating to (i) client advice or recommendations, (ii) the receipt, disbursement or delivery of funds or securities, (iii) the execution of securities purchases or sales and (iv) with certain exceptions, the performance of managed accounts or securities recommendations;
- Southwind violated the Safeguards Rule, which requires registered investment advisers to adopt written policies and procedures that are reasonably designed to safeguard client records and information;
- Southwind violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which require registered investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder, and to review at least annually the adequacy and implementation of such policies; and

- the President caused, and the CCO aided and abetted and caused, Southwind's violations of Sections 204(a) and 206(4) of the Advisers Act and Rules 204-2(a)(7), 206(4)-2 and 206(4)-7 thereunder and the Safeguards Rule

According to the Order, Southwind, the President and the CCO consented to the entry of the Order without admitting or denying the findings therein. Southwind agreed to retain an independent compliance consultant within 30 days of the date of the Order to undertake a review of Southwind's policies relevant to the violations identified in the Order, and Southwind agreed to adopt all recommendations made by such consultant within 60 days of the consultant issuing its findings. Further, Southwind agreed to preserve all records relating to its compliance with the Order for no less than six years and to notify all of its advisory clients of the entry of the Order. Finally, Southwind agreed to certify in writing to its compliance with all of the above undertakings.

According to the Order, Southwind was censured and the CCO may not act in a supervisory or compliance capacity with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent or nationally recognized statistical rating organization. Further, according to the Order, Southwind and the President agreed to jointly and severally pay a civil money penalty of $50,000.

- **See a copy of the Order**

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

John G. Crowley	**212 450 4550**	**john.crowley@davispolk.com**
Lee Hochbaum	**212 450 4736**	**lee.hochbaum@davispolk.com**
Nora M. Jordan	**212 450 4684**	**nora.jordan@davispolk.com**
Leor Landa	**212 450 6160**	**leor.landa@davispolk.com**
Gregory S. Rowland	**212 450 4930**	**gregory.rowland@davispolk.com**
Jennifer Grant Cooper	**212 450 4492**	**jennifer.cooper@davispolk.com**
Oren Gertner	**212 450 4227**	**oren.gertner@davispolk.com**
Trevor I. Kiviat	**212 450 3448**	**trevor.kiviat@davispolk.com**

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