Private Equity Regulatory Update

April 30, 2020

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COVID-19 Update

In addition to the items below, please refer to Davis Polk's **"Coronavirus Updates"** webpage for additional content related to the outbreak.

SEC Division of Investment Management Coronavirus (COVID-19) Response FAQs

On April 14, 2020, Division of Investment Management staff issued FAQs regarding Securities and Exchange Commission ("**SEC**") responses to COVID-19-related issues faced by funds and advisers. Among other things, the staff highlighted recent exemptive orders and no-action relief issued by the SEC and its staff to address such issues. The staff also noted that the SEC's Office of Compliance Inspections and Examinations ("**OCIE**") stated that reliance on such regulatory relief would not be considered a risk factor in determining whether OCIE commences an examination, and generally encouraged registrants to use available regulatory relief as needed. The FAQs also included links to additional staff responses to COVID-19-related questions such as:

- whether an adviser is required to update Form ADV Item 1.F in order to list the temporary teleworking addresses of its employees;
    - the SEC staff's response stated that as long as the employees are temporarily teleworking as part of the adviser's business continuity plan due to circumstances related to COVID-19, it would not recommend enforcement action if the adviser does not update its Form ADV Item 1.F to list the temporary teleworking addresses.
- implications under the Custody Rule of the inadvertent receipt of client securities when an adviser's personnel may be unable to access mail or deliveries at an office location due to the adviser's business continuity plan in response to COVID-19;

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  - the SEC staff's response stated that in such circumstance, it would not consider the adviser to have received client assets at that office location until the adviser's personnel are able to access the mail or deliveries at that office location.
- compliance with the Custody Rule when a pooled investment vehicle fails to distribute its audited financial statements within 120 days after the end of its fiscal year due to certain unforeseeable circumstances;
  - the SEC staff's response stated that it would not recommend enforcement action against an adviser that is relying on Rule 206(4)-2(b)(4) and that reasonably believed that the pooled investment vehicle's audited financial statements would be distributed within the required deadlines, but failed to have them distributed in time under certain unforeseeable circumstances.
- inability to complete surprise examinations required by the Custody Rule due to logistical disruptions related to COVID-19;
  - the SEC staff's response stated that it would not recommend enforcement action against an adviser that reasonably believed that the surprise examination and Form ADV-E filing would be completed by the required deadline, but failed to do so due to logistical disruptions related to COVID-19, as long as the independent public accountant completes the filing as soon as practicable, but not later than 45 days after the original due date.
- Custody Rule compliance for certain privately issued securities that are evidenced by physical certificates, but cannot be kept with a qualified custodian due to the COVID-19 pandemic.
  - the SEC staff's response stated that during the qualified custodian's closure due to COVID-19, until such time as physical certificates can reasonably be placed with a qualified custodian or similar securities can reasonably be issued in compliance with the privately offered securities exception, it would not recommend enforcement action if an adviser does not maintain the certificates with a qualified custodian, provided that: (1) the physical certificates can only be used to effect a transfer or to otherwise facilitate a change in beneficial ownership of the security with the prior consent of the issuer or holders of the outstanding securities of the issuer; (2) ownership of the security is recorded on the books of the issuer or its transfer agent (or person performing similar functions) in the name of the client; (3) the physical certificates contain a legend restricting transfer; (4) the physical certificates are appropriately safeguarded by the adviser and can be replaced upon loss or destruction; and (5) the adviser makes and keeps (in accordance with Rule 204-2) a record of the custodian's closure.
- **See a copy of the FAQs**

SEC Provides Temporary, Conditional Relief for Business Development Companies Making Investments in Small and Medium-Sized Businesses

On April 8, 2020, the SEC announced that it was providing temporary, conditional exemptive relief for business development companies ("**BDCs**") to make additional investments in small and medium-sized businesses ("**portfolio companies**") in response to the effects of COVID-19 on the operations of such businesses. The temporary relief allows additional flexibility for BDCs (i) to issue and sell senior securities and (ii) to participate in certain joint transactions that would otherwise be prohibited by Section 57(a)(4) of the Investment Company Act of 1940, as amended ("**Investment Company Act**") and Rule 17d-1 thereunder. The SEC's order providing the relief (the "**Order**") stated that BDCs were created "to provide capital to smaller domestic operating companies that otherwise may not be able to readily access the

capital markets" and that the SEC recognizes that many BDCs "may face challenges absent these exemptions" in providing such capital due to the effects of COVID-19 on their operations.

The Order continued by indicating that BDCs may face such challenges if "unable to satisfy the asset coverage requirements under the Investment Company Act due to temporary markdowns in the value of the loans to such portfolio companies" or if certain affiliates of BDCs are prohibited from participating in additional investments in BDCs' portfolio companies due to the restrictions in BDCs' existing exemptive orders permitting co-investments. The SEC found that the Order was "necessary and appropriate in order for BDCs to continue providing credit support to portfolio companies impacted by COVID-19." The time period for the exemptions provided by the Order is from April 8, 2020 to the earlier of December 31, 2020 and the date by which the BDC ceases to rely on the Order (the "**Exemption Period**").

In the press release announcing the Order, SEC Chairman Jay Clayton remarked that the Order's "targeted action will enable BDCs to provide their businesses with additional financial support during these times" and that the Order's conditions "are designed to ensure that this temporary relief will both protect and benefit investors in the BDCs."

Issuance and Sale of Senior Securities by BDCs

The Order provides temporary relief from certain asset coverage requirements applicable to BDCs when issuing or selling a senior security that represents indebtedness or is a stock, including the requirement to "determine asset coverage on the basis of values calculated as of a time within forty-eight hours. . . next preceding the time of such determination," subject to certain conditions. The temporary relief allows a BDC to meet the asset coverage ratio required under Section 18(a), as modified by Section 61(a) of the Investment Company Act for BDCs, using an Adjusted Asset Coverage Ratio calculated as follows:

- Calculate the BDC's adjusted portfolio value (the "**Adjusted Portfolio Value**") using values calculated as of December 31, 2019 for securities (i) that the BDC held at December 31, 2019, (ii) that the BDC continues to hold at the time of the issuance or sale of the senior security and (iii) for which the BDC is not recognizing a realized loss; and
- Calculate the BDC's Adjusted Asset Coverage Ratio by reducing its asset coverage ratio (calculated using the Adjusted Portfolio Value) by 25% of the difference between (i) the asset coverage ratio calculated using the Adjusted Portfolio Value and (ii) the asset coverage ratio calculated in accordance with Section 18(b).

Pursuant to the Order, the temporary relief is also conditioned on (1) the BDC making an election to rely on the exemption on Form 8-K, (2) certain limitations on initial investments in portfolio companies, (3) approval of reliance on the Order by the board of directors or trustees of the BDC (the "**Board**"), (4) approval of each issuance of senior securities covered by the Order by the Board, based on certain certifications from the BDC's investment adviser and advice from an independent evaluator regarding the terms and conditions of the proposed issuance, (5) regular reporting to the Board on the BDC's efforts to comply with the asset coverage requirements under Section 18, as modified under Section 61 for BDCs, by the expiration of the Exemption Period, and disclosure on Form 8-K in the event the BDC does not comply with such requirements by the expiration of the Exemption Period; (6) certain recordkeeping requirements regarding related Board materials and (7) certain prohibitions on compensation of affiliated persons of the BDC from portfolio companies in which the BDC invests during the Exemption Period.

Expansion of Relief for BDCs with Existing Co-Investment Orders

The Order also permitted additional flexibility for any BDC to which an SEC order permitting co-investment transactions in portfolio companies with certain affiliated persons is currently applicable. Such flexibility includes permission to participate in a Follow-On Investment with one or more Regulated Funds and/or Affiliated Funds (each term with the meaning ascribed to it in the BDC's existing co-investment order or the meaning ascribed to the substantially similar term used in the BDC's existing co-investment order), subject to certain conditions, including Board oversight.

- See a copy of the Order
- See a copy of the press release announcing the Order

Rules and Regulations

SEC Adopts Offering Reforms for Business Development Companies and Registered Closed-End Funds

On April 8, 2020, the SEC voted to adopt rule amendments (the "**Amendments**") to implement certain provisions of the Small Business Credit Availability Act and the Economic Growth, Regulatory Relief, and Consumer Protection Act impacting business development companies and registered closed-end funds (the "**Impacted Funds**").

According to the adopting release for the Amendments (the "**Adopting Release**"), the SEC adopted the Amendments to modify the registration, communications and offering processes for Impacted Funds, and to allow Impacted Funds to use certain streamlined securities offering rules that are already available to operating companies.

Specifically, the Adopting Release notes that the Amendments will permit Impacted Funds to use a more abbreviated shelf offering process and short-form registration statement if the fund meets certain requirements. The Amendments will also allow Impacted Funds to qualify for well-known seasoned issuer ("**WKSI**") status and benefit from the same flexibility available to operating companies that qualify as WKSIs. Additionally, the Amendments will allow for Impacted Funds to use certain communication rules currently available to operating companies, including the use of a "free writing prospectus," and allow Impacted Funds to satisfy their final prospectus delivery obligations by filing the prospectuses with the SEC. The Amendments also create a new method for interval funds, a type of closed-end fund that offers to repurchase a portion of its shares at regular intervals, and certain exchange-traded products not registered under the Investment Company Act, to pay registration fees in a manner similar to the way that mutual funds and exchange-traded funds pay registration fees. Additionally, the Amendments expand the scope of Rule 486 under the Securities Act of 1933, as amended (the "**Securities Act**"), which permits funds to make certain changes to their registration statements on an immediately-effective basis or on an automatically effective basis a set period of time after filing, to include closed-end funds that do not operate as interval funds. The Amendments also impose certain structured data requirements and periodic reporting requirements on Impacted Funds similar to those existing for mutual funds and exchange-traded funds. Finally, the Amendments eliminate the requirement for Impacted Funds to provide new purchasers with copies of all previously filed materials that have been incorporated by reference into a registration statement, but would allow Impacted Funds to make those documents available on a website instead.

The Amendments will become effective on August 1, 2020, except for the amendments related to registration fee payments by interval funds and exchange-traded products, which will become effective on August 1, 2021. According to the press release announcing the Amendments, the SEC is adopting the following compliance dates for the requirements under the Amendments:

- August 1, 2021: the requirement for registered closed-end funds to provide management's discussion of fund performance in their annual reports to shareholders.
- August 1, 2022: Inline eXtensible Business Reporting Language ("**Inline XBRL**") structured data reporting requirements for financial statement, registration statement information, and prospectus information for affected funds that are eligible to file a short-form registration statement. For all other affected funds subject to these structured data reporting requirements, the compliance date is February 1, 2023.

- February 1, 2022: the requirement that Form 24F-2 filers (including existing filers) file reports on Form 24F-2 in an XML structured data format.
- **See a copy of the Adopting Release**

Litigation

SEC Settles with Investment Adviser for Alleged Undisclosed Conflicts of Interest Regarding In-House Operations Fees

On April 22, 2020, the SEC issued an order (the "**Monomoy Order**") instituting and settling cease-and-desist proceedings against Monomoy Capital Management, L.P. ("**Monomoy**"), a private equity fund adviser, arising out of Monomoy's alleged practice of charging portfolio companies for the services of its in-house Operations Group without adequately disclosing this practice to investors. Although the pace of enforcement actions regarding alleged conflicts of interest arising from allocation of expenses between managers and investors has decreased in recent years,[1] the Monomoy Order serves as a reminder that this remains a key area of enforcement focus.

Monomoy manages several private equity funds, including a complex of funds described in the Monomoy Order as "**Fund II**". Fund II was governed by a limited partnership agreement ("**LPA**") and private placement memorandum ("**PPM**") that described the management of Fund II, and explained that Monomoy charges Fund II a management fee of 2% of the limited partner's committed capital for the initial five years of the fund's life, and, thereafter, a management fee of 2% of the limited partner's invested capital.

The Monomoy Order explains that since 2007, Monomoy provided portfolio companies with the services of its Operations Group; Monomoy described the Operations Group in the Fund II PPM and in Fund II marketing materials. The SEC alleges that Monomoy had an "established practice" of billing portfolio companies for the costs of providing Operations Group services, rather than covering the costs of the Operations Group through Monomoy's management fee. According to the Monomoy Order, from April 2012 through December 2016, fees paid by Fund II portfolio companies for Operations Group services represented about 13.3% of all revenue Monomoy received with respect to Fund II during that period.

The SEC alleges that Monomoy did not "fully and fairly disclose" that it would separately charge Fund II's portfolio companies for the Operations Group costs or the conflicts of interest associated with this practice, and that Monomoy did not obtain informed consent from limited partners for these conflicts of interest. Prior to 2014, Monomoy's disclosures allegedly did not describe any reimbursement that Monomoy would receive for the cost of Operations Group services. Notably, although the Fund II LPA did disclose that portfolio companies were responsible for paying Monomoy fees, including "closing fees, investment banking fees, placement fees, monitoring fees, consulting fees, directors' fees and other similar fees," the LPA allegedly did not mention the Operations Group or specifically disclose that Monomoy would receive reimbursement for Operations Group services to portfolio companies. While Monomoy did file, in March 2014, a Form ADV that disclosed "under specific circumstances, certain Monomoy operating professionals may provide services to portfolio companies that typically would otherwise be performed by third parties," and that "Monomoy may be reimbursed" for costs related to such

[1] For an in-depth overview of the SEC's settlements with investment advisers regarding fee and expense allocation, see **Allocating Fees and Expenses: The SEC Is Paying Close Attention**, The International Comparative Legal Guide to: Alternative Investment Funds 2017, 5th Edition.

services," the SEC alleges that those statements did not adequately disclose that Monomoy "routinely" provided and was reimbursed for such services.

The SEC alleged that as a result of the conduct described above, Monomoy violated Section 206(2) of the Advisers Act. The Monomoy Order notes that Monomoy cooperated with the SEC staff throughout the investigation. Monomoy agreed to cease and desist from future violations, to be censured, and to pay a total of $1,926,579: $1,521,972 in disgorgement, $204,606 in prejudgment interest, and $200,000 in civil monetary penalties.

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

SEC Settles with Investment Adviser for Alleged Advertising Omissions

On April 17, 2020, the SEC issued an order (the "**OIE Order**") instituting and settling cease-and-desist proceedings against Old Ironsides Energy, LLC ("**Old Ironsides**"), a registered investment adviser, arising out of alleged material omissions from Old Ironsides' marketing materials.

Old Ironsides advised a private fund, Old Ironsides Energy Fund II LP ("**OIE Fund**"). The principals of Old Ironsides had previously managed a portfolio of oil and gas investments (which the OIE Order calls the "**Legacy Portfolio**") for their previous employer. The Legacy Portfolio contained direct drilling investments, private equity investments, and private fund investments. The OIE Order states that the "vast majority" of investments in the Legacy Portfolio were direct drilling investments.

Old Ironsides' marketing materials stated that the OIE Fund would only invest in direct drilling investments, private equity investments, and midstream assets, and emphasized the principals' management of the Legacy Portfolio. Marketing materials also provided a "Track Record," which was described as the investment performance of early stage direct drilling investments in the Legacy Portfolio. The SEC alleges that the track record contained in marketing materials categorized a private fund investment as an early stage direct drilling investment, and that the marketing materials did not describe how that fund investment differed from early stage direct drilling investments.

According to the SEC, including that private fund in the calculation of the track record improved the track record, as at the time that the marketing materials were created the private fund investment had a return of 10.9x, while investments in early stage direct drilling investments had lower returns.

At the time Old Ironsides prepared these materials, Old Ironsides' compliance manual included policies and procedures that prohibited any advertisement containing a material false statement or that omitted material facts, as well as policies and procedures governing the use of investment performance in marketing materials. The SEC alleges that Old Ironsides failed to implement these compliance policies and procedures in allowing the distribution of marketing materials that omitted material information about the calculation of the performance of the Legacy Portfolio.

The SEC alleged that on account of its conduct, Old Ironsides violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which require a registered investment adviser to adopt and implement policies and procedures reasonably designed to prevent violation of the Advisers Act and rules under the Advisers Act, and Rule 206(4)-1(a)(5) thereunder, which make it a "fraudulent, deceptive, or manipulative" act or practice to publish or distribute advertisements that contain untrue statements of material fact or that are otherwise false or misleading.

Old Ironsides agreed to cease and desist from future violations, to be censured, and to pay $1,000,000 in civil monetary penalties.

- **See a copy of the Old Ironsides Order**

SEC Obtains Partial Summary Judgment Against Investment Adviser and Principal

On February 13, 2020, the SEC won partial summary judgment in its pending action against Navellier & Associates, Inc. ("**Navellier**"), an investment adviser, and its founder and chief investment officer, Louis Navellier. The SEC action against Navellier and Louis Navellier has been pending since August 2017.

In its complaint, filed in the U.S. District Court for the District of Massachusetts, the SEC alleged that Louis Navellier and his firm misled clients about the track record of the "Vireo AlphaSector" strategy Navellier offered, and ignored and concealed "red flags" indicating that the strategy was not performing as advertised.

According to the complaint, around September 2009, Navellier began to explore doing business with F-Squared, a former investment adviser that marketed a strategy called "AlphaSector." In a 2014 SEC enforcement action, F-Squared admitted that it had made false claims about the AlphaSector strategy's performance and "fabricated" a performance record by back-testing. As Navellier explored doing business with F-Squared, Navellier's CCO conducted due diligence which "failed to corroborate" F-Squared's claims. Navellier never "checked F-Squared's claimed historical performance," which the SEC alleges would have revealed that F-Squared's performance information was false. Navellier's CCO allegedly cited four factors that led to his decision to recommend the F-Squared AlphaSector products: that another fund family had conducted diligence and partnered with F-Squared, that F-Squared was reporting trades after October 2008, that the F-Squared Board of Advisors included well-known individuals, and that the CCO found the "backgrounds of the principals" of F-Squared favorable.

Navellier incorporated charts and data based on the F-Squared AlphaSector strategy, even though F-Squared had not provided Navellier with any support for its claims. Navellier also allegedly represented that the AlphaSector strategy had outperformed various investment benchmarks from 2001 through 2008, and that its performance was based on a track record of actual investments. By March 2011, Navellier allegedly learned that the AlphaSector track record was back-tested and not based on actual investments, but nonetheless continued to repeat F-Squared's claims about AlphaSector to Navellier clients. In August 2018, Navellier sold its Vireo AlphaSector business to F-Squared for $14 million; Navellier allegedly never corrected its representations to clients, nor did it disclose the conflict of interest created by the sale to F-Squared.

On February 13, 2020, Judge Casper granted the SEC's motion for summary judgment that Navellier and Louis Navellier violated Sections 206(1) and 206(2) of the Advisers Act. Judge Casper concluded that the undisputed facts demonstrated that defendants had made false claims about AlphaSector, and that they knew that their statements regarding the AlphaSector track record were false but nonetheless continued to use these claims to market the AlphaSector strategy.

Judge Casper also rejected Navellier and Louis Navellier's affirmative defense of selective enforcement, in which they posited that the SEC had not brought civil suits against others that did business with F-Squared. Because the SEC offered a rational basis for a civil suit against these defendants—that they allegedly ignored SEC warnings and were aware that F-Squared's marketing materials were false and nonetheless continued to use them—Judge Casper granted the SEC summary judgment denying their selective enforcement defense.

- **See a copy of the Summary Judgment 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.

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