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The US Regulation of Foreign Funds in the Age of Cryptocurrencies

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THE US REGULATION OF FOREIGN FUNDS

IN THE AGE OF CRYPTOCURRENCY

GENERAL BACKGROUND

- Fund regulation is an extremely technical area. This course is ***not*** a detailed description of the various rules for the registration of US funds with the Securities and Exchange Commission (the "SEC") and the Commodities and Futures Trading Commission (the "CFTC").
- Rather, this CLE program is designed to describe the constraints on foreign funds that wish to raise capital or conduct activities in the United States, either directly or through agents, ***without having to register*** with the SEC or the CFTC and subject themselves to the onerous registration burdens on the registered fund.

GENERAL BACKGROUND – SECURITIES LAW CONSIDERATIONS

- Under the Securities Act, all offers and sales of securities must either be registered with the Securities and Exchange Commission (the "SEC") or effected by means of an exemption from registration. There are two principal exemptions that would apply to the fund's contemplated activities in the US: Rule 506(b) and Rule 506(c).
- Under Rule 506(b), offers and sales of securities may be made without registration, provided following requirements are met:
- There can be no general solicitation or advertising to market the securities;
- Securities may not be sold to more than 35 non-accredited investors. "Accredited investors" are defined to include, among other categories, "family clients" of "family offices," registered investment advisers, LLC's with assets in excess of $5 million, other entities with investments in excess of $5 million, and individuals with income in excess of $200,000 (or $300,000 together with a spouse or spousal equivalent) in each of the prior two years; and
- Because of the restrictions around making offers and sale of securities to non-accredited investors, and because the income test for individuals is relatively low, many, if not most, offerings under Rule 506(b) simply exclude non-accredited investors.
- **[Tab 1 – Rule 506(b)]**

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GENERAL BACKGROUND – SECURITIES LAW CONSIDERATIONS

- Under Rule 506(c), general solicitation and advertising are permitted, provided only accredited investors purchase the offered securities. The Rule requires issuers to take reasonable steps to "verify" each investor's status. Because "verification" can be difficult, the SEC has established certain verification "safe harbors":
- Status based on income can be verified by reviewing any Internal Revenue Service form that reports the purchaser's income for the two most recent years and obtaining a written representation from the purchaser that he or she has a reasonable expectation of reaching the income level necessary to qualify as an accredited investor during the current year.
- Status based on net worth can be verified by reviewing one or more of the following types of documentation dated within the prior three months and obtaining a written representation from the purchaser that all liabilities necessary to make a determination of net worth have been disclosed:
  - Assets: Bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments and appraisal reports issued by independent third parties; and
  - Liabilities: A consumer report from at least one of the nationwide consumer reporting agencies.
- Alternatively, status can be verified by obtaining a written confirmation from one of the following persons or entities that such person or entity has taken reasonable steps to verify that the purchaser is an accredited investor:
  - A registered broker-dealer;
  - An investment adviser registered with the Securities and Exchange Commission;
  - A licensed attorney is in good standing; or
  - A certified public accountant who is duly registered and in good standing.
- Initially, the verification requirements were prohibitive, but recently intermediaries willing to take on the verification risk for a price have emerged and compliance with Rule 506(c) has become substantially less burdensome, provided issuers are willing to bear the intermediaries' verification costs.

GENERAL BACKGROUND – INVESTMENT COMPANY ACT CONSIDERATIONS (1)

- The Investment Company Act generally requires all investment funds to register with the SEC and become subject to very onerous disclosure requirements, record and book-keeping rules, and substantive investment restrictions. Most foreign funds view SEC registration to be prohibitively complex and burdensome and will forego the US market rather become subject to the relevant SEC rules. There are two main exemptions relied on: Section 3(c)(1) and Section 3(c)(7) of the Investment Company Act.
- **Section 3(c)(1) – the 100 hundred beneficial holder rule**. Section 3(c)(1) of the Investment Company Act provides a fund is excluded from the definition of an investment company (and thus not required to register) if it is:
- **Any issuer whose outstanding securities** (other than short-term paper) **are beneficially owned by not more than 100 persons** (or, in the case of a qualifying venture capital fund, discussed in more detail below, 250 persons) and which is not making and does not presently propose to make a public offering of its securities.
  - **Beneficial ownership by a company is deemed to be beneficial ownership by one person**, except that, if the company owns 10% or more of the outstanding voting securities of the issuer, and is or would otherwise be an investment company, the beneficial ownership shall be deemed to be that of the holders of such company's outstanding securities (other than short-term paper).
  - Although the text of the law is silent on this point, the SEC has made clear that only **US beneficial owners** need to be counted. It is also worth noting that a husband and wife who invest jointly in the fund only count as a single owner, as would an individual who invests both in his or her own name and through an IRA of which he or she is the sole owner. Certain "knowledgeable employees" (essentially officers and directors of the fund) are also not considered "beneficial owners."
  - In ***Touche Remnant & Co.*** (publicly available Aug. 27, 1984), the staff of the **SEC concluded that a foreign fund could make a private offering in the United States without registration if the fund had fewer than 100 US beneficial owners**. **[Tab 2 – Touche Remnant & Co SEC No-Action Letter]**

GENERAL BACKGROUND – INVESTMENT COMPANY ACT CONSIDERATIONS (11)

- **<u>Section 3(c)(7) – the qualified purchaser exemption</u>.** This Section provides another frequently relied upon exemption for funds whose securities are sold exclusively to "qualified purchasers," who are any of the following:
  - **(i) <u>any natural person</u>** (including any person who holds a joint, community property or other similar shared ownership interest in an issuer that is excepted under section 80a–3(c)(7) of this title with that person's qualified purchaser spouse) **<u>who owns not less than $5,000,000 in investments</u>**, as defined by the Commission;
  - **(ii) <u>any company that owns not less than $5,000,000 in investments</u>** and that is owned directly or indirectly by or for 2 or more natural persons who are related as siblings or spouses (including former spouses), or direct lineal descendants by birth or adoption, spouses of such persons, the estates of such persons, or foundations, charitable organizations or trusts established by or for the benefit of such persons;
  - **(iii)** any trust that is not covered by clause (ii) and that was not formed for the specific purpose of acquiring the securities offered, as to which the trustee or other person authorized to make decisions with respect to the trust, and each settlor or other person who has contributed assets to the trust, is a person described in clause (i), (ii) or (iv); or
  - **(iv) <u>any person, acting for his or her own account or the accounts of other qualified purchaser</u>, <u>who</u>** in the aggregate **<u>owns and invests on a discretionary basis, not less than $25,000,000</u>** in investments.
  - **[Tab 3 - 15 U.S. Code § 80a–2(51)(A)]**
- Similarly to Section 3(c)(1), **for foreign funds the relevant "qualified purchasers" are only US purchasers**. In a no-action letter to the law firm of Goodwin Proctor, the SEC stated: "A Foreign Fund that was making a private placement in the United States in reliance on Section 3(c)(7) would have to determine whether the U.S. person was a qualified purchaser." **[Tab 4 – Goodwin Procter & Hoar No-Action Letter]**

GENERAL BACKGROUND – BROKER-DEALER CONSIDERATIONS (1)

- **Section 3(a)(4)(A) of the Securities Exchange Act generally defines a "broker" broadly** as "any person engaged in the business of effecting transactions in securities for the account of others." The SEC provides the following guidance: sometimes you can easily determine if someone is a broker. For instance, a person who executes transactions for others on a securities exchange clearly is a broker. However, other situations are less clear. For example, each of the following individuals and businesses may need to register as a broker, depending on a number of factors:
- "**Finders" and "business brokers**," investment advisers and financial consultants;
- Persons that operate or control electronic or other platforms to trade securities;
- Persons that act as "placement agents" for private placements of securities;
- Persons that effect securities transactions for the account of others for a fee, even when those other people are friends or family members;
- Persons that provide support services to registered broker-dealers; and
- Persons that act as "independent contractors," but are not "associated persons" of a broker-dealer.
- **[Tab 5 – Guide to Broker-Dealer Registration]**
- **The most problematic category for foreign funds is often that of "finders."** The SEC has acknowledged this problem and recently approved a final rule proposal that would exempt "finders" from the scope of the Securities Exchange Act definition of a "broker." **[Tab 6 - SEC Proposes Conditional Exemption for Finders]**
- However, the proposed rule was a product of the Trump administration and it is unclear how the new administration views the issue philosophically. **[Tab 7 - Is the SEC Finally Ready to Clarify this Cloudy Issue]**

GENERAL BACKGROUND – BROKER-DEALER CONSIDERATIONS (II)

<u>There are 2 main exemptions for the agents of foreign funds:</u>

<u>Rule 15a-6(3)</u>. Foreign funds often rely on Rule 15a-6, which permits associated persons of foreign broker-dealers to conduct certain broker-dealer activities in the United States as long as (1) they are "chaperoned" in the US by a registered US broker-dealer, except in certain communications with major institutional investors (investors with assets greater than $100 million), which may be conducted without a chaperone; (2) the transactions in the foreign entity's securities are effected through a registered US broker dealer; and (3) a range of record-keeping and other rules are complied with. The principal rules are the following:

- First, any transactions resulting from the US activities must be effected through a registered US broker-dealer.
- Second, the foreign-broker dealer (the foreign fund) must agree to provide the SEC with information requested by the SEC relating the transactions covered by the exceptions, unless the foreign entity is prohibited by law from furnishing such information.
- Third, the associated persons of the foreign fund must generally be accompanied on visits to US investors by an associated person of a registered broker or dealer who accepts responsibility for the foreign associated person's communications with the US investor (the "**chaperone**").
- Fourth, an associated person of a registered US broker's dealer must be present for all oral communications with US investors, other than those with "major institutional investors," or institutional investors with more than $100 million in assets. **[Tab 9 - Registration Requirements for Foreign Broker-Dealers]**
  - In 1997, the SEC issued no-action relief to 9 of the leading US investment banks with foreign affiliates (the so-called "Nine-Firms Letter"). Under the Nine-Firms Letter, **<u>associated persons of a foreign unregistered broker-dealer may have in-person unchaperoned contacts with major institutional investors</u>**, in addition to the clearly permitted oral communications, and may contact US institutional investors by telephone from outside the US outside of stock exchange trading hours. **[Tab 10 - Securities Activities of US-Affiliated Foreign Dealers SEC No-Action Letter]**
- Fifth, there are various reporting, disclosure and procedural requirements, such as agreeing to provide information on request to the SEC and consenting to US Jurisdiction for potential lawsuits, that must be complied with.
- **[Tab 8 - 17 CFR § 240.15a-6]**

GENERAL BACKGROUND – BROKER-DEALER CONSIDERATIONS (II) CONT.

<u>Rule 3a4-1</u>. A separate exemption may be available under Rule 3a4-1 for "associated persons" of the foreign fund such as officers, directors and employees, who:

- primarily perform, or are intended primarily to perform at the end of the offering, substantial duties for or on behalf of the issuer otherwise than in connection with transactions in securities;
- were not brokers or dealers, or associated persons of a broker or dealer, within the preceding 12 months; and
- do not participate in selling an offering of securities for any issuer more than once every 12 months.
- **[Tab 11 - 17 CFR § 240.3a4-1]**

GENERAL BACKGROUND – INVESTMENT ADVISERS ACT CONSIDERATIONS (1)

- The final area of potential regulatory concern for foreign funds with activities in the US is the Investment Advisers Act ("Advisers Act"). The SEC takes a very expansive view of the concept of "advice" and considers that activities as limited as sharing a stock list with an investor constitute "advice." The SEC has specifically stated that "providing a selective list of securities is advice about securities even if no advice is provided as to any one security." **[Tab 12 - Regulation of Investment Advisers]**
- Nonetheless there are few exemptions that may provide relief to the fund.
- **Background**: On July 21, 2010, President Obama signed into law the Dodd-Frank Act, which repealed certain portions of the Investment Advisers Act and provided 3 new exemptions from registration. **[Tab 13 - Final Rule Exemptions for Advisers]**
- First, Section 203(l) of the Advisers Act provides that an investment adviser that solely advises **venture capital funds** is exempt from registration under the Advisers Act (the venture capital exemption). **[Tab 13 at 5]**
- Second, section 203(m) of the Advisers Act provides an exemption from registration to any investment adviser that solely advises **private funds** if the adviser has assets under management in the United States of less than $150 million (the private fund adviser exemption). The venture capital fund and private fund exemptions still require the adviser to file certain information with the SEC and are thus called "exempt reporting advisers." **[Tab 13 at 5-6]**
- Section 203(b)(3) of the Advisers Act, as amended by the Dodd-Frank Act, provides an exemption for certain **foreign private advisers** (the foreign private adviser exemption) who have no place of business in the United States, have fewer than 15 clients in the United States and less than $25 million in aggregate assets under management from such clients and investors. The Dodd-Frank also created a separate exemption excluding advisers to "family offices" from the definition of "investment adviser." **[Tab 13 at 16 and Note 16]**

GENERAL BACKGROUND – INVESTMENT ADVISERS ACT CONSIDERATIONS (II)

- For purposes of section 203(l) of the Investment Advisers Act **a venture capital fund is any private fund that**:
- (1) Represents to investors and potential investors that it pursues a venture capital strategy;
- (2) Immediately after the acquisition of any asset, other than qualifying investments or short-term holdings, **holds no more than 20% of the amount of the fund's aggregate capital contributions** and uncalled committed capital **in assets** (other than short-term holdings) **that are not qualifying investments**, valued at cost or fair value, consistently applied by the fund;
- (3) Does not borrow, issue debt obligations, provide guarantees or otherwise incur leverage, **in excess of 15% of the private fund's aggregate capital contributions** and uncalled committed capital, and **any such borrowing**, indebtedness, guarantee or leverage **is for a non-renewable term of no longer than 120 calendar days**, except that any guarantee by the private fund of a qualifying portfolio company's obligations up to the amount of the value of the private fund's investment in the qualifying portfolio company is not subject to the 120 calendar day limit;
- (4) Only issues securities the terms of which do not provide a holder with any right, except in extraordinary circumstances, to withdraw, redeem or require the repurchase of such securities but may entitle holders to receive distributions made to all holders pro rata; and
- (5) Is not registered under section 8 of the Investment Company Act of 1940 and has not elected to be treated as a business development company (with a class of securities registered with the SEC).
- **[Tab 13 at 203-204]**

GENERAL BACKGROUND – INVESTMENT ADVISERS ACT CONSIDERATIONS (II) CONT.

- The key requirement is **that the fund must invest 80% of its capital** in "**qualifying investments**." These are **investments in equity securities issued by a "qualifying portfolio company"** that has been acquired directly by the private fund from the qualifying portfolio company. A qualifying portfolio company, in turn, is a company that:
  - At the time of any investment by the **private fund, is not reporting or foreign traded** and does not control, is not controlled by or under common control with another company, directly or indirectly, that is reporting or foreign traded **in connection with the private fund's Investment in such company;**
  - **Does not borrow** or issue debt obligations and distribute to the private fund the proceeds of such borrowing or issuance in exchange for the private fund's investment; and
  - Is **not** an investment company, a private fund, an issuer that would be an investment company but for the exemption provided in Section 3(a)(7) or a **commodity pool.**
  - **[Tab 13 at 205]**

GENERAL BACKGROUND – INVESTMENT ADVISERS ACT CONSIDERATIONS (III)

- Private Fund Advisers Exemption.
- There are 2 basic requirements for the private fund adviser exemption:
  - the fund must advise "qualifying private funds" exclusively; and
  - must not have more than $150 million in assets attributable to US investors under management.
- A qualifying private fund means:
- **any private fund that is not registered under the Investment Company Act** and has not elected to be treated as a business development company pursuant to section 54 of that Act.
- **As a reminder, Section 3(c)(1) exempts funds with fewer than 100 beneficial owners. Section 3(c)(7) exempts funds that all of whose investors are "qualified purchasers." [Tab 14 at 5-7]**
- Reliance on the private fund exemption implies a very different strategy from reliance on the venture capital fund exemption.
- **[Tab 14 - Private Fund Adviser Overview]**

GENERAL BACKGROUND – INVESTMENT ADVISERS ACT CONSIDERATIONS (IV)

- <u>Foreign Private Fund Advisers Exemption</u>. This exemption would apply if **the fund has fewer than 15 US investors with less than $25 million in assets under management attributable to US investors**. Using one or more US feeder funds would most likely not work as a means of avoiding the strict requirements of the rule because **the SEC will "look through" any nominee structure to determine beneficial ownership**.

  In this connection, the SEC has stated:

  "More importantly, defining the term investor by reference to sections 3(c)(1) and 3(c)(7) places appropriate limits on the ability of a non-U.S. adviser to avoid application of the registration provisions of the Advisers Act by setting up intermediate accounts through which investors may access a private fund and not be counted for purposes of the exemption. **Advisers must look through nominee and similar arrangements to the underlying holders of private fund-issued securities to determine whether they have fewer than 15 clients and private fund investors in the United States**."

  [Tab 13 at 108]

- <u>Family Office Advisers Exemption</u>. The final potential exemption on which a foreign fund and its agents could rely is the "family office" exemption. This exemption applies if the fund provides advice **exclusively to family offices**. Given the growing importance of family offices in the wealth management world, the SEC devoted an entire release solely to this issue. A "family office" is defined as a company (including its directors, partners, members, managers, trustees and employees acting within the scope of their position or employment) that:

  - (1) Has no clients other than family clients; provided that if a person that is not a family client becomes a client of the family office as a result of the death of a family member or key employee or other involuntary transfer from a family member or key employee, that person shall be deemed to be a family client for purposes of this section 275.202(a)(11)(G)-1 for one year following the completion of the transfer of legal title to the assets resulting from the involuntary event;
  - (2) Is wholly owned by family clients and is exclusively controlled (directly or indirectly) by one or more family members and/or family entities; and
  - (3) Does not hold itself out to the public as an investment adviser.

- **[Tab 15 – Final Rule Family Offices]**

SO YOUR CLIENT IS THINKING

OF SETTING UP A CRYPTOCURRENCY FUND

THE BASICS

- First, the fund will need to work within the general regulatory framework discussed above:
  - Registration? Availability of Rule 3(a)(1) and 3(a)(7)?
  - Promotion:
    - Need to structure activities to come within exemption from SEC registration - Rules 506(b) and (c)
    - Broker-dealer exemption: Rule 15(a)(6)
    - Investor Advisers Exemption: Venture Capital Fund Exemption, Private Fund Exemption, Private Foreign Fund Exemption and Family Office Exemption
- In addition, the fund will have to consider:
  - Regulation by the Commodities and Futures Trading Commission: Commodity Pool Operator issues
  - Regulation by the Financial Crimes Enforcement Network (FINCEN): Money Laundering issues
  - State law regulation: Licensing, including in NY a "BitLicense"
  - Tax issues – beyond the scope of this course, but know that generally the IRS considers cryptocurrency to be "property" subject to taxation and not a currency.

KNOW YOUR CRYPTOCURRENCIES (I)

- There are currently over 4,000 different cryptocurrencies in existence.
- The most popular cryptocurrencies include Bitcoin, Ethereum, Bitcoin Cash, Litecoin, DOT, Stellar (Lumens), Monero, Tether, Binance, Chainlink, Ripple (XRP) and Dogecoin.
- While the underlying legality of many digital assets themselves is widely acknowledged, some crytocurrencies are questionably legal and their inclusion in a fund could create problems.

KNOW YOUR CRYPTOCURRENCIES (II)

- Investing in cryptocurrency means taking on risks, but getting scammed shouldn't be one of them. Reports to the FTC's Consumer Sentinel suggest scammers are cashing in on the buzz around cryptocurrency and luring people into bogus investment opportunities in record numbers. Since October 2020, reports have skyrocketed, with nearly 7,000 people reporting losses of more than $80 million on these scams. **[Tab 16 - Cryptocurrency buzz drives record investment scam losses]**
- The median loss reported is $1,900. Compared to the same period a year earlier, that's about 12 times the number of reports and nearly1,000% more in reported losses.
- Then, there are "giveaway scams," supposedly sponsored by celebrities or other known figures in the cryptocurrency space, that promise to immediately multiply the cryptocurrency you send, but in doing so, people reported that they would discover later that they had been simply sending their crypto directly to a scammer's wallet. For example, people have reported sending more than $2 million in cryptocurrency to Elon Musk impersonators just over the period from December 2020 through May 2021.

KNOW YOUR CRYPTOCURRENCIES (III)

- Report fraud and other suspicious activity involving cryptocurrency to:
  - the FTC at ReportFraud.ftc.gov;
  - the Commodity Futures Trading Commission (CFTC) at CFTC.gov/complaint;
    - Individuals can file either a complaint or a Form TCR;
      - Individuals who submit a Form TCR will receive anti-retaliation protections if applicable, and may be eligible for monetary awards of up to 30% of the money collected as a result of their information; or
  - the US Securities and Exchange Commission (SEC) at sec.gov/tcr.

DUE DILIGENCE, DUE DILIGENCE, DUE DILIGENCE

- Even well-known cryptocurrencies should be carefully evaluated.
- Because of the potential for fraud and, especially, regulatory intervention, the fund should be extremely selective about the cryptocurrencies in which it will invest.
- A long history of acceptance by the marketplace or even the regulators is not a guarantee of legality.
  - The Uber/Tesla approach of breakneck development and hoping to get too big to fail may not work with cryptocurrencies, given that they pose a direct threat to central banks, governments dependent on fiat currency and traditional banks.
  - The SEC's lawsuit against Ripple is a perfect illustration of this point.

RIPPLE AND TETHER

TWO CAUTIONARY TALES

RIPPLE

- What is Ripple?
- First, it is not a song by the Grateful Dead.
- Ripple is not a cryptocurrency. Ripple is short for the name of the company Ripple Labs, Inc. that developed the XRP "protocol" or cryptocurrency.
- Here's what Investopedia says:
  - XRP is the native cryptocurrency for products developed by Ripple Labs. Its products are used for payment settlement, asset exchange and remittance systems that work more like SWIFT, a service for international money and security transfers used by a network of banks and financial intermediaries.
- Here's the SEC:
  - XRP is a digital asset (or cryptocurrency) that can be issued or transferred using a **distributed ledger**—a peer-to-peer database spread across a network of computers that records all transactions publicly. Sec. & Exch. Comm'n v. Ripple Labs, Inc., No. 20-CV-10832 (AT)(SN), 2021 WL 1335918, at *1 (S.D.N.Y. Apr. 9, 2021) **[Tab 24 – Complaint Ripple Labs, Inc., et al]**
- Importantly, XRP is <u>**pre-mined**</u> and uses a less complicated method of mining as compared to Bitcoin.
- What does that mean? In simple terms, it means XRP already existed from the inception of Ripple, somewhat like the treasury stock of a corporation that is then "issued" or distributed to network participants. Bitcoin, in contrast, has to be actively mined by miners using massive amounts of energy and computational power.

SIDE NOTE – WHAT IS A DISTRIBUTED LEDGER?

- There is a lot of talk about "blockchains" and the cryptography of cryptocurrencies, but it is important to understand that all blockchain cryptocurrencies work off of a "distributed ledger."
- A distributed ledger is a log of transactions stored on multiple computers. In Bitcoin, these computers are called nodes. The nodes all work together to update and store the ledger with all the transactions that take place.
- A somewhat helpful analogy is the difference between a Google Doc versus a Microsoft Word document. If many people are working on an MS Word document, you end up needing one person to keep a "master" copy to control who's updating what. With a Google doc, many people can work on the same document while Google updates the document for all users.
- But Google Docs are stored on "central" servers maintained by Google.
- In a distributed ledger, copies of the document – the ledger – are kept on completely independent powerful computers called nodes. Each node stores a copy of the ledger; a change made in a copy anywhere updates the ledger everywhere.
- A "blockchain" is a kind of distributed ledger.

RIPPLE'S XRP DISTRIBUTED LEDGER

- The XRP Ledger is software code that operates as a peer-to-peer database spread across a network of computers that records transaction data. It was designed to be a superior alternative to Bitcoin because it was more secure and did not involve inefficient mining of any tokens needed to transact. In 2012, when the XRP Ledger was deployed to the servers that would run it, a fixed supply of 100 billion of the token native to the XRP Ledger—what became known as "XRP"—was automatically created. **[Tab 26 – SEC v. Ripple, 20-cv-10832, Dkt. 107]**
- Ripple described XRP as "the equivalent to paper cash in the physical world," a "Unit of Account," "Medium of Exchange" and "Store of Wealth." Mr. Chris Larsen, one of the co-founders, also stated publicly on numerous occasions that he considered XRP to be a currency. For example, in a February 19, 2014 interview, Mr. Larsen stated that XRP "is a math-based currency like [b]itcoin" because it is "a currency without a counterparty."
- During Mr. Larsen's tenure as CEO, multiple government agencies agreed with Mr. Larsen's view that XRP was a currency, not a security—all while the SEC remained silent. We'll come back to this **fair notice issue**.

SEC'S COMPLAINT
RIPPLE SOLD XRP TO FINANCE OPERATIONS

- From 2013 to the filing of the Complaint, Ripple engaged in unregistered offers and sales of securities. Ripple used the means and instrumentalities of interstate commerce to offer and sell XRP to investors in the US, without a registration statement being filed or in effect.
- Ripple raised at least $1.38 billion by selling XRP without providing investors—including retail investors, in whose hands Ripple's securities ultimately came to rest—the type of financial and managerial information typically provided in such statements by hundreds of issuers every year.
- Among other things, Ripple and its executives promoted XRP as an investment into a common enterprise that would increase in value and price based on Ripple's efforts. This included taking steps to control the supply and price of XRP and creating an active and liquid trading marked for XRP—that is a market in which investors could quickly and easily buy and sell XRP. Ripple offered and sold XRP to raise the capital it needed to fund its operations. Indeed, from 2013 through the end of the third quarter of 2020, almost all of Ripple's revenues came from sale of XRP to investors. **[Tab 27 - SEC v. Ripple, 20-cv-10832, Dkt. 182]**

SEC'S COMPLAINT: RIPPLE AND THE *HOWEY* TEST

- SEC claims **XRP is an investment contract under the Howey test**. *See S.E.C. v. W.J. Howey Co.*, 328 U.S. 293, 298–99 (1946) (holding that an "investment contract...means **a contract, transaction or scheme** whereby ***a person invests his money*** in a **common enterprise** and **is led to expect profits** solely **from the efforts of a promoter or a third party**"). **[Tab 25 - SEC v. Howey]**
  - Contract, transaction or scheme
  - Investment of money
  - Common enterprise
  - Expectation of profits
  - "From the efforts of a promoter or a third party"

- Courts have moved away from a literal interpretation of Howey toward economic realities and totality of the circumstances view of the alleged scheme:
  - *Glen-Arden Commodities, Inc. v. Costantino*, 493 F.2d 1027, 1034 (2d Cir. 1974) ("The question therefore becomes whether...in light of the economic reality and the totality of circumstances...the customers were making an investment.").

RIPPLE'S MOTION TO DISMISS AND REPLY
RIPPLE IS A UTILITY TOKEN NOT A SECURITY

- There are 2 key issues:
  - Is Ripple a security or a "utility token?" Is XRP something that was intrinsically useful and had value for that reason, or was it just a security that had value because of what other people (i.e., Ripple and its team) were doing?
  - Did Ripple have fair notice?
- Key distinction between "security token" and "utility token", *i.e.*, a token that is used for some purpose on the network, like say a golf cart used to drive around a golf range.

- If the owner of a golf club financed operations by selling golf carts, controlling the supply of golf carts or even by creating secondary markets where used golf carts could be bought and sold, would that make the golf cart a "security?" Common sense says no, but the SEC has a somewhat nuanced view. Something that is not a security (let's say an orange) can become a security depending on how it is marketed and what investment decisions are made. But surely golf carts can't be securities. Then, how is a utility token different?
- Or, let's go back to the Grateful Dead: let's say an enterprising DeadHead makes and develops the coolest tie-die shirts that are used by the DeadHead as a substitute for money to get tickets, drugs, refreshment, what have you. Let's say the t-shirt guy is really a major manufacturer developing its business by selling t-shirts and corners the market in Deadhead paraphernalia so that it can influence the price. If I buy a t-shirt directly from the manufacturer hoping it will go up in value, does that make it a security?
- The SEC repeatedly confuses Mr. Garlinghouse's, Ripple's current CEO, alleged knowledge that XRP was an asset with value and utility with supposed knowledge that it was a security. **[Tab 28 - SEC v. Ripple, 20-cv-10832, Dkt. 224. Reply]**

RIPPLE'S MOTION TO DISMISS AND REPLY
FAIR NOTICE AND CONFLICTS OF INTEREST

- XRP was created in 2012.
- Ripple had been distributing XRP for nearly a decade before the SEC sued.
- Unlike with Tether, discussed in a little bit, the SEC never sought an injunction or took action to stop Ripple from distributing (and selling) XRP to finance the construction of its network.
- Given that, did Ripple have "fair notice" that it was engaging in illegal distributions of securities without registration? [Side note: Ripple also had opinions of counsel that XRP was not a security.] Why did the SEC act the way it did?
- This leads us to a real problem within the public policy arena when it comes to cryptocurrency. In the last days of the previous administration, and on the very last day of his tenure as head of the Securities and Exchange Commission, SEC Chair Jay Clayton oversaw the filing of a lawsuit against Ripple, the creator of the cryptocurrency XRP.
- Clayton then went to work for One River Digital Asset Management, an investment fund focused exclusively on Bitcoin and Ether, rivals to XRP. **[Tab 46 - With Crypto, Congress, Not Agencies, Should Decide What's Next]**

RIPPLE RESOURCES

- **[Tab 17 - SEC v. Ripple Why is the Lawsuit Taking so Long]** https://financefeeds.com/sec-v-ripple-lawsuit-taking-long/
- **[Tab 18 - SEC warns Court that a Ripple win on Fair Notice defense would nullify Howie Test]** https://financefeeds.com/sec-warns-court-that-a-ripple-win-on-fair-notice-defense-would-nullify-howie-test/
- **[Tab 19 – SEC v. Ripple Labs Podcast]** https://fedsoc.org/events/sec-v-ripple-labs-cryptocurrency-and-regulation-by-enforcement

TETHER FACTS

- The popular messaging channel Telegram, owned by the Russian Mark Zuckerberg, Pavel Durov, who founded Russia's largest social networking site, VK, sought to create a new blockchain to be rival to blockchains such as Bitcoin. Telegram itself does not have any advertising, unlike Twitter and Facebook. Durov's idea was to create a new network, called The Open Network, or TON, and attract Telegram users as the network participants.
- To finance TON, Durov indirectly marketed "Grams," which were digital tokens that would be used on the network once it was built.
- The "Grams" were sold pursuant to Gram Purchase Agreements that set October 31, 2019 as the "Deadline Date" for Telegram to fulfill its obligations to create a working blockchain and deliver Grams. If Telegram failed to meet the Deadline Date, the Gram Purchase Agreements entitled the initial purchasers to reimbursement of their investment minus any expenses.
- Importantly, this contractual deadline was not tied to any promise or guarantee that Grams could actually be used to buy goods and services and depended solely on Telegram's ability to create and launch the TON Blockchain. Telegram agreed that the Purchase Agreements were investment contracts and thus securities. The Purchase Agreements were structured as future contracts that allowed investors to receive tokens once TON was launched. As futures were only sold to accredited investors, the offering was exempt from registration as securities under Regulation D of the Securities Act of 1933,
- Telegram, advised by Skadden Arps, maintained that the Grams were utility tokens because they would be used as currency on the TON Blockchain once it was fully developed. In the Offering Documents, Telegram spoke of potential future uses for Grams, specifically, as a medium of exchange for goods and services (or cryptocurrency), to purchase not-yet-developed tools on the TON (e.g., network storage, blockchain-based domain names, identity-hiding services), and as a token for future unspecified uses that Telegram and other third parties might eventually develop. None of these uses of Grams existed at any time and Grams did not have legal tender status in any jurisdiction.
- The value of the Grams would depend on the future development of the network that would not be completed at the time of the delivery of the Grams.
- SEC sued to enjoin the sale of the Grams at the expiration of the Gram Purchase Agreements, arguing that the Grams were securities because their value was far in excess of any conceivable use on the TON Blockchain.

TETHER FACTS

- SEC v. Telegram, 19-cv-09439 **[Tab 29 - SEC v. Telegram, 19-cv-09439, Dkt. 1]**
- The SEC brings this emergency action to stop Defendants—owners and operators of the mobile messaging application Telegram Messenger—from continuing their ongoing illegal offering of digital-asset securities called "Grams." According to SEC, Grams are securities because nothing can be bought or sold with them. Telegram conducted the initial offering under exemptions from registration.
- Once Telegram delivers the Grams to the Initial Purchasers, it will be able to resell billions of Grams on the open market to the investing public. Telegram and/or its affiliates will facilitate these sales on digital-asset trading platforms. Once these resales occur, Telegram will have completed its unregistered offering with billions of Grams trading on multiple platforms to a dispersed group of investors.
- Telegram's illegal offering (the "Offering") had an initial stage, which took place between January and March 2018. During this stage, Telegram raised approximately $1.7 billion from sales of approximately 2.9 billion Grams to 171 purchasers (the "Initial Purchasers"). A large portion of this capital came from US investors: Telegram sold more than 1 billion Grams to 39 US Purchasers, raising $424.5 million from the US market
- **[Tab 30 - SEC Halts Alleged $1.7 Billion Unregistered Digital Token Offering]**
- Case settles in June 2020. Telegram pays $18.5 million in penalty. As part of the settlement, Telegram agreed to repurchase the futures contracts to make the initial purchasers whole.

TETHER
THE RISK TO FUNDS

- After the SEC settlement, one of the funds that had invested in Tether, a Russian fund called Da Vinci, sued Telegram in the High Court in London. The procedure appears sealed, but the basic claim is that Telegram's offer to repurchase the token was too little, too late, and did not give the fund enough time to make its decision, causing them loss.
- Telegram offered investors a choice of either receiving back 72% of their funds or lending them to Telegram for a year and receiving 110% of their investments in 2021.
- "Our fund got the offer 24 hours before the deadline, and many of our investors simply did not get a chance to analyze the documents and, therefore, they were not able to get a proper return on their investments," Zhelezko said. When the project was closed, investors were getting conflicting messages and struggled to decide what to do, he said.
- **[Tab 32 - Investors in Failed TON Project Sue Telegram]**

RIPPLE AND TETHER
THE PROBLEM OF REGULATORY CAPTURE

- Former US Securities and Exchange Commission (SEC) Chairman Jay Clayton has taken an advisory role at hedge fund One River Digital Asset Management, the parent company of the newly launched digital asset fund One River Digital.
- In a press release on Monday, One River Digital Asset Management, which manages over $2.5 billion in institutional assets, announced Clayton would join the firm's newly formed Academic and Regulatory Advisory Council along with economist Jon Orszag, and former White House adviser Kevin Hassett.
- Clayton led the SEC during its crackdown on unregistered and fraudulent initial coin offerings. During that time the commission also refused to approve the application of any Bitcoin (BTC, +11.31%) exchange-traded funds and sued Ripple Labs. **[Tab 33 - Former SEC Chairman Jay Clayton to Advise One River Asset Management on Crypto]**
- Former Director of the Division of Corporation Finance, William Hinman, declared Ether was not a security and then joined Ethereum foundation.

CRYPTO FUNDS AND PRACTICAL ISSUES: THE BITLICENSE

THE NEW YORK BITLICENSE

- **The BitLicense**
- Pursuant to the Part 200.Virtual Currencies regulations, any persons involved in "virtual currency business activity" in New York must obtain a license known as the "BitLicense." The regulation defines a "virtual currency business activity" as:
- receiving virtual currency for transmission or transmitting virtual currency, except where the transaction is undertaken for non-financial purposes and does not involve the transfer of more than a nominal amount of virtual currency;
- **storing, holding, or maintaining custody or control of virtual currency on behalf of others**;
- buying and selling virtual currency as a customer business;
- performing exchange services as a customer business; and
- controlling, administering, or issuing a virtual currency.
- **[Tab 20 - NY Codes, Rules and Regulations, Part 200.2 Definitions]**
- **BitLicense Application**
- In order to receive the license, an applicant must complete a 30-page Application for License to Engage In Virtual Currency Business Activity and pay a $5,000 application fee. The application requires information on the history of the business, its owners and operators, operational items, financials, information on AML procedures and information on its general compliance processes. In total, the application is fairly onerous and costly and will likely deter many potential companies for applying for the license. Few BitLicenses have actually been granted to date, and those that have been granted were to major players in the industry such as Coinbase and Ripple. *See* https://hedgefundlawblog.com/new-york-bitlicense.html
- **[Tab 21 – Bitlicense Application Checklist]**

THE BITLICENSE
COMPETING VIEWS

Yes: Plain text

- For New York fund managers, you are required to be licensed if you are maintaining custody or control on behalf of others. As a fund manager, you typically have ultimate discretionary authority over decisions made on behalf of the fund and its investors, control over the trades conducted, as well as ultimate control and custody - thus the assets and investors' capital within the fund. *See* https://www.capitalfundlaw.com/blog/newyorkbitlicense

No: Custodian has keys, not the fund

- BitLicense categories really seem to apply to those groups who are acting as cryptocurrency exchanges and/or are offering "wallet" type services. For most fund managers who are simply managing a fund which is investing in virtual currencies, the above items would not implicate the managers if they operate through custodians who actually hold the "keys" to the underlying virtual currency. *See* https://hedgefundlawblog.com/new-york-bitlicense.html

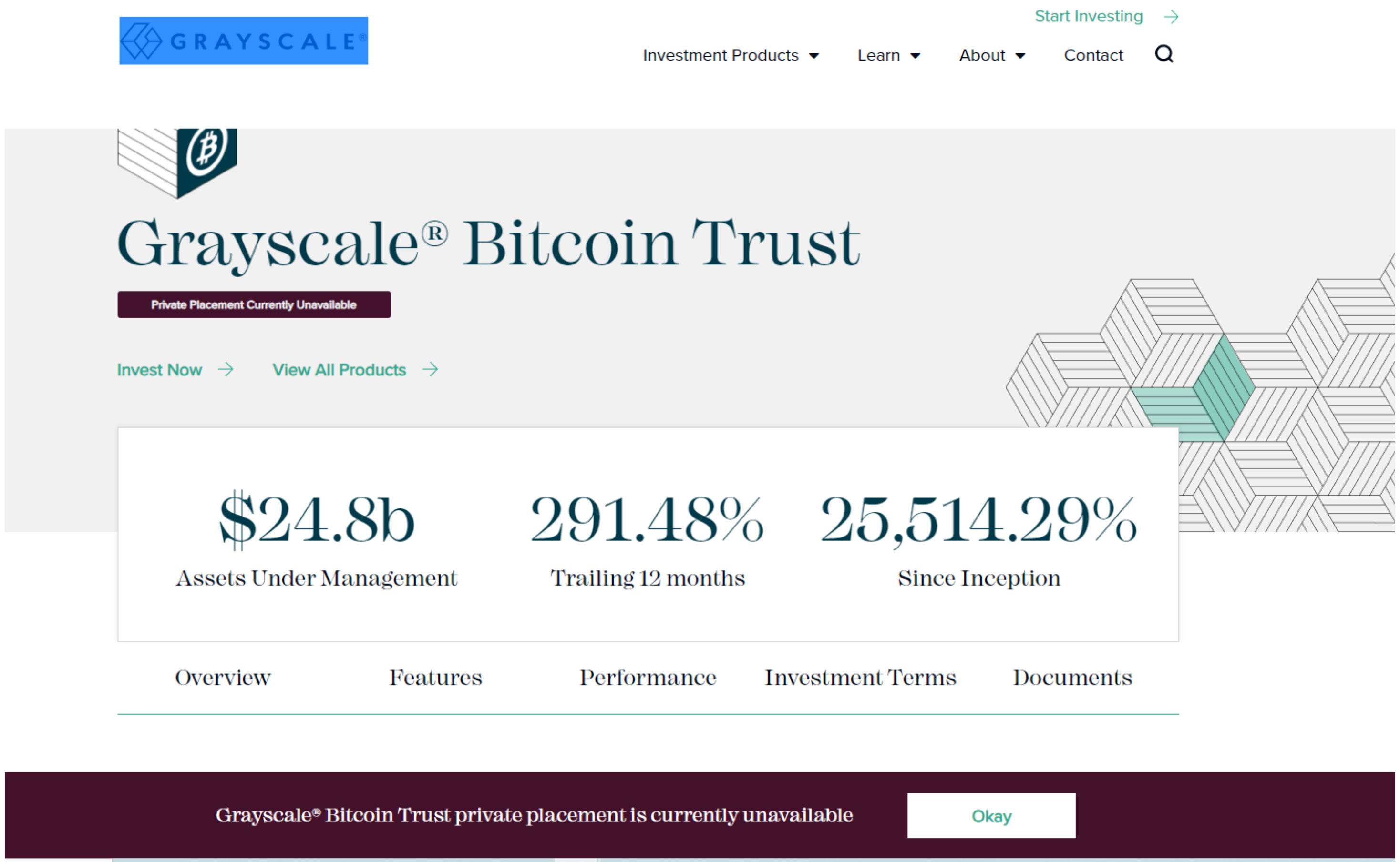
SIDE NOTE: CRYPTOCURRENCY "KEYS"

- There are 2 kinds of cryptographic "keys": public keys and private keys.
- *See* "Understanding Bitcoin with Mental Models: https://www.youtube.com/watch?v=56s_3LNDDqw&list=PL-DSKYgOHhD6iPlTFkBCVMij_Oc2-5m-f&index=1 **[Tab 31 – Understanding Bitcoin with Mental Models].** The video maker explains**:**
- Bitcoin uses cryptography to create a key pair that controls access to Bitcoin on the blockchain. Each Bitcoin key pair consists of a public and private key.
- A Bitcoin private key is simply a large (256 bits) secret number that allows Bitcoin to be unlocked and sent. Each private key creates a unique signature that authorizes the transaction of Bitcoin for the owner. It's called a private key because it is meant to be kept private and not shown to other people.
- A Bitcoin public key is another large number but allows Bitcoin to be locked and received. It's called a public key because it is meant to be shared publicly and enables you to receive funds.
- You can think of public-key cryptography as a lock, but with two keys instead of one:
  - These two keys (or numbers) are related mathematically on the secp256k1 elliptic curve. The private key is a randomly generated number plotted on the curve, and the corresponding public key is a related point on that curve.
- The real point of this curve is that it creates **trap door** functionality, meaning that once we generate the first point on the curve (the private key) the corresponding second point (public key) is easily found but impossible to find in the opposite direction. If the user has the private key then the user always has the public key, but if other users have the public key it's mathematically impossible for them to do the reverse to find the private key.
- Most retail consumers don't own the private keys to their crypto assets. The Custodian, such as Coinbase, owns the private keys. **[Tab 38: Coinbase S-1]** However, Coinbase has developed a product, the Coinbase Wallet, that allows users to control their own private keys. *See Coinbase Wallet Review:* https://video.search.yahoo.com/search/video?fr=mcafee&ei=UTF-8&p=coinbase+wallet&type=E211US105G0#id=2&vid=3793d669a8319cfdd9f603ac2a56810c&action=view **[Tab 47 – Coinbase Wallet Review]**
- Short take on the Coinbase Wallet: don't try it at home unless you are already fairly sophisticated.

CURRENT MARKET PRACTICE: THE BITCOIN TRUST

GRAYSCALE AND OSPREY

THE BITLICENSE – CURRENT MARKET PRACTICE FOR FUNDS



THE BITLICENSE –
USE A TRUST AND A CUSTODIAN

Use a Trust and enter into an agreement with a Custodian (such as Coinbase) so that the fund (or Trust) does not physically hold any cryptocurrency. Here is the language from Grayscale Bitcoin Trust's Annual Report:

Safekeeping of Bitcoins

- The Custodian will use best efforts to keep in safe custody on behalf of the Trust all Bitcoin received by the Custodian. All Bitcoin credited to the Digital Asset Account will (i) be held in the Digital Asset Account at all times, and the Digital Asset Account will be controlled by the Custodian; (ii) be labeled or otherwise appropriately identified as being held for the Trust; (iii) be held in the Digital Asset Account on a non-fungible basis; (iv) not be commingled with other digital assets held by the Custodian, whether held for the Custodian's own account or the account of other clients other than the Trust; (v) not without the prior written consent of the Trust be deposited or held with any third-party depositary, custodian, clearance system or wallet; and (vi) for any Digital Asset Account maintained by the Custodian on behalf of the Trust, the Custodian will use best efforts to keep the private key or keys secure, and will not disclose such keys to the Trust, the Sponsor or to any other individual or entity except to the extent that any keys are disclosed consistent with a standard of best efforts and as part of a multiple signature solution ***that would not result in the Trust or the Sponsor "storing, holding, or maintaining custody or control of" the Bitcoin "on behalf of others" within the meaning of the New York BitLicense Rule (23 NYCRR Part 200) as in effect as of June 24, 2015 such that it would require the Trust or the Sponsor to become licensed under such law***.
- **[Tab 22 - Grayscale Annual Report on Form 10-K]**

THE BITLICENSE – DISCLOSURE

- Typical disclosure language highlights the regulatory uncertainty surrounding the Bitlicense and would be advisable in a crypto fund information statement or PPM:

If regulatory changes or interpretations of the Trust's or Sponsor's activities require the licensing or other registration as a money transmitter or business engaged in digital currency activity (e.g. **under the New York BitLicense regime**) (or equivalent designation) under state law in any state in which the Trust or Sponsor operates, **the Trust or Sponsor may be required to seek licensure** or otherwise register and comply with such state law. In the event of any such requirement, to the extent that the Sponsor decides to continue the Trust, the required registrations, licensure and regulatory compliance steps may result in extraordinary, nonrecurring expenses to the Trust. Regulatory compliance would include, among other things, implementing anti-money laundering and consumer protection programs.

- **[Tab 23 – Osprey Information Sheet]**

THE CFTC AND COMMODITY POOL OPERATORS

THE COMMODITIES AND FUTURES TRADING COMMISSION

- The mission of the CFTC is to foster open, transparent, competitive and financially sound markets. By working to avoid systemic risk, the Commission aims to protect market users and their funds, consumers and the public from fraud, manipulation and abusive practices related to derivatives and other products that are subject to the Commodity Exchange Act (CEA).
- The definition of "commodity" in the CEA is broad. It can mean a physical commodity, such as an agricultural product (e.g., wheat, cotton) or natural resource (e.g., gold, oil).
  - It can also mean a currency or interest rate.
  - The CEA definition of "commodity" also includes "all services, rights, and interests. . . In which contracts for future delivery are presently or in the future dealt in." **[Tab 34 - A CFTC Primer on Virtual Currencies]**

THE CFTC AND CRYPTOCURRENCIES: CRYPTOCURRENCIES ARE COMMODITIES

- The CFTC first found that Bitcoin and other virtual currencies are properly defined as commodities in 2015.
- **[Tab 35 - Order Coinflip Inc. dba Derivabit et al]**
- Section 1a(9) of the CEA Act defines "commodity" to include, among other things, "all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in." 7 U.S.C. § 1a(9). The definition of a "commodity" is broad. *See*, e.g., Board of Trade of City of Chicago v. SEC, 677 F. 2d 1137, 1142 (7th Cir. 1982). Bitcoin and other virtual currencies are encompassed in the definition and properly defined as commodities.

THE CFTC AND CRYPTOCURRENCIES
CFTC AND SEC HAVE CONCURRENT JURISDICTION

In 2017, the SEC released a report about an Initial Coin Offering (or "ICO") (the "DAO Report"). **[Tab 36 - The DAO Report]**

The DAO was a Decentralized Autonomous Organization, a "virtual" organization embodied in computer code and executed on a distributed ledger or blockchain. Investors exchanged Ether, a virtual currency, for virtual DAO "Tokens" to fund projects in which the investors would share in anticipated earnings. DAO Tokens could be resold on web-based platforms.

- Based on the facts and circumstances, the SEC determined that DAO Tokens are "securities" under the federal securities laws.
- The CFTC, however, views these same tokens as commodities. According to the SEC, there is no inconsistency between the SEC's analysis and the CFTC's determination that virtual currencies are commodities.
- The CFTC looks beyond form and considers the actual substance and purpose of an activity when applying the federal commodities laws and CFTC regulations.

THE CFTC AND CRYPTOCURRENCIES REGISTRATION REQUIREMENTS

The CFTC requires registration of any:

- Commodity Pool Operator — an individual or organization that operates a commodity pool and solicits funds for that commodity pool;
- Commodity Trading Advisor — an individual or organization that, for compensation or profit, advises others, directly or indirectly, as to the value of or the advisability of trading futures contracts, options on futures, retail off-exchange forex contracts or swaps;
- Futures Commission Merchant — an entity that solicits or accepts orders to buy or sell futures contracts, options on futures, retail off-exchange forex contracts or swaps, and accepts money or other assets from customers to support such orders;
- Introducing Broker — an individual or organization that solicits or accepts orders to buy or sell futures contracts, forex, commodity options, or swaps but does not accept money or other assets from customers to support these orders; or
- Associated Person — an individual who solicits orders, customers or customer funds (or who supervises persons so engaged) on behalf of a futures commission merchant, retail foreign exchange dealer, introducing broker, commodity trading advisor or commodity pool operator.
- **[Tab 37 - CFTC Jurisdiction Over Cryptocurrency]**

THE CFTC AND CRYPTOCURRENCIES
THE COMMODITY POOL OPERATOR PROBLEM

- A commodity pool operator (CPO) is an individual or organization that operates a commodity pool and solicits funds for that commodity pool. **A commodity pool is an enterprise in which funds contributed by a number of persons are combined for the purpose of trading futures or options on futures, retail off-exchange forex contracts, or swaps, or to invest in another commodity pool**.
- Typically, funds will use some leverage or engage in some hedging activities to protect themselves from movements in the price of different investments. Using leverage essentially brings the transaction into the purview of CFTC registration.
- CPO registration is required unless the CPO qualifies for one of the exemptions from registration outlined in CFTC Regulations 4.5 or 4.13.
- **[Tab 40 – Section 4.5 Exemption]**
- **[Tab 41 – Section 4.13 Exemption]**

THE CFTC AND CRYPTOCURRENCIES SECTION 4.13 EXEMPTION

- CFTC Regulation §4.13(a)(3) exemption is the one most often used by private fund managers and is referred to as the de minimis exemption.
- CFTC Regulation §4.13(a)(3) exempts CPOs operating pools that utilize a "de minimis" level of futures or swaps trading (i.e., either: (1) the aggregate initial margin on futures positions and premiums on options on futures do not exceed 5% of the liquidation value of the fund's portfolio, after taking into account unrealized gains and losses (typically used for options); or (2) the aggregate notional value of such positions does not exceed 100% of the liquidation value of the pool's portfolio, after taking into account unrealized gains and losses (typically used for swaps)). **Unlike the regulatory assets under management buffers under the Investment Advisers Act of 1940, as amended, there are no *notional value* buffers** in respect of the de minimis exemption; if a fund manager enters into a future or swap under the CFTC's jurisdiction that causes a pool to exceed the trading limitations at any point in time, the fund manager will no longer be exempt from CPO registration under CFTC Regulation §4.13(a)(3).
- Accordingly, general partners of funds that use futures, but only within the defined minimum amounts, can rely on this exemption.
- There are a number of additional requirements to consider in determining whether one qualifies for the de minimis exemption. These include the following:

  (a) interests in the pool must be exempt from registration under the Securities Act of 1933,

  (b) funds must not market themselves as trading in commodity futures, commodity options or swaps' markets

  and (c) participants in the pool must be limited to "accredited investors" or "knowledgeable employees" as defined under Rule §3c-5 of the Investment Company Act of 1940, as amended.6
- In addition, CPOs relying on the de minimis exemption who have filed a notice of exemption from registration must affirm on an annual basis the notice of exemption from registration, withdraw such exemption due to the cessation of activities requiring registration or exemption therefrom, or withdraw such exemption and apply for registration within 60 days of the calendar year end. *See* Guidance on CPO and CTA Annual Affirmations Requirements Due By February 29, 2016 and General Compliance Requirements for Commodity Pools and Advisors in the U.S. and the EU *https://www.reedsmith.com/en/perspectives/2015/12/guidance-on-cpo-and-cta-annual-affirmations-requir*

THE CFTC AND CRYPTOCURRENCIES SECTION 4.5 EXEMPTION

- Regulation §4.5 excludes from the definition of CPO "qualifying entities" that operate pools that are regulated by some other regulatory authority, such as the SEC. A "qualifying entity" for purposes of Regulation §4.5 will include the following:
  - a registered investment company under the Investment Company Act of 1940 that complies with certain trading limitations and marketing restrictions;
  - an insurance company with respect to the operation of a separate account;
  - a bank, trust company or any financial depository institution with respect to the assets of a trust, custodial or other separate unit of investment for which it is acting as a fiduciary and for which it is vested with investment discretion;
  - a trustee of, named fiduciary of, or an employer maintaining, a pension plan that is subject to ERISA Title I, and certain plans are not even considered pools (including Title I non-contributory plans, Title IV contributory plans, government plans, employee welfare plans, and church plans).

THE CFTC AND CRYPTOCURRENCIES
THE COMMODITY POOL OPERATOR PROBLEM

- A foreign cryptocurrency fund that wishes to avoid CFTC registration should not use margin or engage in any cryptocurrency derivate transactions. This will ensure that the Section 4.13 exemption applies. Foreign cryptocurrency funds typically include the following disclaimer:

  The Fund will not trade, buy, sell or hold Bitcoin derivatives including Bitcoin futures contracts. The Fund is solely authorized to take immediate delivery of Bitcoin. The Fund is not, and does not expect to become, regulated by the Commodity Futures Trading Commission ("CFTC") under the Commodity Exchange Act as a "commodity pool," and will not be operated by a CFTC-regulated commodity pool operator because it will not trade, buy, sell or hold Bitcoin derivatives, including Bitcoin futures contracts.

- **[Tab 39 – Pantera Capital Private Placement Memorandum]**

THE CFTC AND CRYPTOCURRENCIES
COMMODITY TRADING ADVISERS ("CTA")

- Who is a CTA?
- A CTA is a person who, for pay, regularly engages in the business of advising others as to the value of commodity futures, options or swaps or the advisability of trading in commodity interests or issues analyses or reports of the same. Providing advice also includes exercising trading authority over a customer's account as well as giving advice based upon knowledge of or tailored to a customer's particular commodity interest account, particular commodity interest trading activity, or other similar types of information.
- In a fund that has no separate investment adviser, the general partner or managing member is both CPO and CTA and need not separately register as a CTA if it is already registered as a CPO. In a corporate structure, the directors are usually the CPOs unless delegation is made to the adviser, and the adviser is the CTA. In a separate account, the investment adviser is the CTA and there is no CPO.
- Exemption from CTA Registration
- There are 3 exemptions which will most likely apply to private fund advisers that are:
  - CFTC Regulation §4.14(a)(8) "de minimis exemption" – a CTA whose CPO qualifies for the de minimis exemption can be exempt from CTA registration if such CTA (i) is registered (or exempt from registration) as an investment adviser with the Securities and Exchange Commission (the SEC), (ii) provides commodity interest trading advice solely incidental to its business on advising in securities investments, and (iii) does not hold itself out as a CTA.
  - CFTC Regulation §4.14(a)(10) "15 or less exemption" – a CTA that has no more than 15 clients (with each fund typically counting as one client) during the prior 12 months and does not hold itself out to the public as a CTA. A fund that receives advice based on its own investment objectives and not the objectives of individual clients will count as one client. A CTA whose principal place of business is outside of the US need only count clients that are US residents.
  - CEA Section §4(m)(3) "not primarily exemption" – a CTA that is registered with the SEC as an investment adviser is exempt from registration as a CTA if its business is not "acting primarily" as a CTA and it does not advise a commodity pool "engaged primarily" in investing in commodity interests.

NON-DERIVATIVES
LIABILITY FOR FRAUD IS WITHIN THE JURISDICTION OF THE CFTC

- While the CFTC regulatory authority over cryptocurrency generally only extends to cryptocurrency derivatives, the CFTC has asserted jurisdiction over direct trading of cryptocurrencies. This is because the Commodities Exchange Act, which is applied and interpreted by the CFTC, creates liability for fraud in the trading of physical commodities. **[Tab 48 - 7 U.S. Code § 6c]**
- Section 6(c)(1) of the Commodity Exchange Act (CEA) prohibits the use or attempted use of any manipulative or deceptive device, untrue or misleading statements or omissions, or deceptive practice, in connection with any swap or contract of sale of any commodity in interstate commerce, or for future delivery.
- On September 21, 2017, the CFTC filed for injunctive relief against Gelfman Blueprint Inc, and its CEO, Nicholas Gelfman concerning an alleged Ponzi scheme. The CFTC asserted jurisdiction on the basis of Mr. Gelfman engaging in some Bitcoin trading, thereby engaging in manipulative trading in commodities.
- In August 2018, CabbageTech Corp was found guilty of fraudulent behavior in another case brought by the CFTC for "a deceptive and fraudulent virtual currency scheme." The CFTC has historically asserted jurisdiction over spot market commodities trading, where manipulative trading in the spot market can affect its derivatives market.
- The Gelfman case is unique in that the CFTC asserted jurisdiction over the spot market when there was little to no derivatives trading in the United States. *See CFTC v. Gelfman Blueprint*, No. 17-7181 (S.D.N.Y. Sept. 21, 2017). **[Tab 42 - Gelfman Blueprint Inc]**
- Similarly, the CabbageTech case did not indicate that there was any derivatives trading conducted, yet the court rejected the defendant's claim that the CFTC had no jurisdiction in the matter. *See CFTC vs. Patrick K. McDonnell, and Cabbagetech, Corp. d/b/a Coin Drop Markets*, (No. 18-CV-0361) (E.D.N.Y. Aug. 24, 2018). **[Tab 43 - Commodity Futures Trading Comm'n v. McDonnell]**

THE FINANCIAL CRIMES ENFORCEMENT NETWORK OF THE U.S. DEPARTMENT OF THE TREASURY ("FINCEN")
A TRAP FOR THE UNWARY

DOES A CRYPTOCURRENCY FUND NEED A MONEY TRANSMITTER LICENSE?

- As we have already noted, the Financial Crimes Enforcement Network, or FINCEN, considers cryptocurrency to be. . .a "currency." In a sense, this directly contradicts the SEC's view of cryptocurrencies as securities. Individuals dealing in cryptocurrency transactions need to be concerned about money laundering. Funds also need to be concerned about money laundering, but as we have seen, the structure that works to avoid Bitlicense pitfalls results in a scheme in which the fund has no knowledge about the "keys" that are used to access the underlying cryptocurrency.
- The practical concern for a cryptocurrency funds is whether it is engaged in the "money services business" and would need a "money transmitter" license." The money services business includes any person doing business, whether or not on a regular basis or as an organized business concern, in one or more of the following capacities:
- (1) *Currency dealer or exchanger*.
  (2) Check casher.
  (3) Issuer of traveler's checks, money orders or stored value.
  (4) Seller or redeemer of traveler's checks, money orders or stored value.
  (5) ***Money transmitter***.
  (6) U.S. Postal Service.
- No activity threshold applies to the definition of money transmitter. Thus, a person who engages as a business in the transfer of funds is an MSB as a money transmitter, regardless of the amount of money transmission activity.
- FINCEN licensing rules do not apply to a person registered with, and regulated or examined by, the Securities and Exchange Commission or the Commodity Futures Trading Commission. Assuming the foreign fund does not want to (or cannot) be registered with the SEC or the CFTC, it needs to be concerned about this issue.

FINCEN REGISTRATION

- Under FinCEN's regulations, a person or entity engaging in **money transmission** must register as a "money services business," develop an AML (anti-money laundering program) and adhere to federal reporting and recordkeeping requirements.
- In the United States, the essential elements of an AML program are set out in the Bank Secrecy Act implementing regulations (31 CFR Chapter X): (1) a system of internal controls; (2) independent testing for compliance; (3) the designation of an individual to coordinate and monitor day-to-day compliance; and (4) training of appropriate personnel.
- An AML program should establish and implement risk-based policies and procedures designed to prevent facilitation of money laundering or the funding of terrorism, including the reporting of suspicious transactions with FinCEN. Failure of a money services business to register as a money services business, develop and adequately implement an AML program or adhere to federal reporting and recordkeeping requirements may result in severe civil and criminal penalties for the money services business and/or those individuals who operate it.
- In addition, just when you though you were safe, FINCEN also requires you to get a state license, such as the Bitlicense in every state in which the fund does business.

IS THE FUND A MONEY TRANSMITTER?

- According to FinCEN, a "money transmitter" is defined as a person who provides money transmission services, or engages in the transfer of funds.
- "Money transmission services" equal the "acceptance of currency, funds, or other value that substitutes for currency from one person and the transmission of currency, funds or other value that substitutes for currency to another location or person by any means."
- "Other value that substitutes for currency" is broad enough to cover virtual currencies.
- Companies who accept virtual currency from one party to another party and vice versa, or exchange fiat currency for any digital currency would be considered money transmitters.
- **[Tab 45 - Money Services Business Definition]**
- On its face, this creates a problem.

IS THE FUND A MONEY TRANSMITTER? SOLUTION: USE AN INDIRECT STRUCTURE

- Funds need to be very carefully structured to ensure that they do not become "money transmitters."
- One potential solution is the Grayscale Bitcoin Trust and the Osprey Bitcoin Trust: the cryptocurrency is held by the Custodian so the Trust never actual exchanges cash from investors for cryptocurrency.
- This seems to elevate form over substance, however. The real bet by entities like Grayscale and Osprey is that funds or trusts were not really what FinCEN was getting at with its concerns over money transmission, notwithstanding the very broad statutory language.
- However, there is a real risk that should be understood by fund managers and explained to investors.

FINCEN REGISTRATION SOLUTION: DISCLOSURE

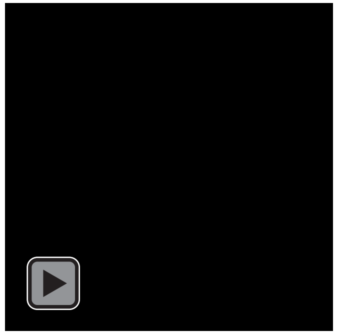
- Grayscale Bitcoin Trust simply discloses the problem away: explains they may be required to register and that the costs of such registration would be "extraordinary" and could lead to the dissolution of the Bitcoin Trust.
- Osprey Bitcoin Trust states:

  To the extent the Trust or Sponsor is found to have operated without appropriate state or federal licenses, it may be subject to investigation, administrative or court proceedings, and civil or criminal monetary fines and penalties, all of which would harm the reputation of the Trust or its Sponsor, decrease the liquidity of the Trust, and have a material adverse effect on the price of the Units. If the Sponsor decides to comply with such additional federal or state regulatory obligations and continue the Trust, the required registrations, licensure and regulatory compliance steps may result in extraordinary, nonrecurring expenses to the Trust, possibly affecting an investment in the Units in a material and adverse manner. Furthermore, the Trust and its service providers may not be capable of complying with certain federal or state regulatory obligations applicable to money service businesses' money transmitters and businesses involved in digital currency business activity. If the Sponsor and/or the Trust determines not to comply with such requirements, the Sponsor will act to dissolve and liquidate the Trust. Any such termination could result in the liquidation of the Trust's Bitcoin at a time that is disadvantageous to Unitholders.

FINCEN AND ILLICIT COUNTERPARTIES
KYC AND THE SILK ROAD

- Although Bitcoin transaction details are logged on the blockchain, a buyer or seller of Bitcoin may never know to whom the public key belongs or the true identity of the party with whom it is transacting. Public key addresses are randomized sequences of 27-34 alphanumeric characters that, standing alone, do not provide sufficient information to identify users.
- Transacting with a counterparty making illicit use of Bitcoin could have adverse consequences. On October 2, 2013, the FBI seized the domain name for the infamous "Silk Road" website—an online black marketplace for illicit goods and services—and arrested its alleged founder, Ross William Ulbricht.
- The website operated through multiple systems of strict anonymity and secrecy, requiring a Tor browser for access and using Bitcoin as the exclusive means of payment for illicit goods and services. As part of the raid, the FBI also seized over 26,000 Bitcoin from accounts on Silk Road, which were worth approximately $3.6 million at the time (over $1 billion today). In November 2020, the U.S. Department of Justice seized more than $1 billion in Bitcoin from an account linked to the Silk Road website. On January 27, 2014, the CEO of BitInstant (the New York-based Bitcoin exchange service) was arrested on charges of money laundering and operating an unlicensed money transmitting business.
- On July 24, 2017, FinCEN assessed a $110 million civil money penalty against BTC-e a/k/a Canton Business Corporation ("BTC-e"), an internet-based and foreign located digital currency exchange founded in 2011, for failing to register as a Money Services Business and facilitating crimes like drug sales and ransomware attacks. FinCEN also assessed separate $12 million fine against BTC-e's owner, Alexander Vinnik.
- **[Tab 44 - Ross Ulbricht's Testimony]** [Audio: https://bitcoinmagazine.com/culture/silk-road-ross-ulbricht-from-prison]

ROSS ULBRICHT - TESTIMONY



[Tab 44 – Extract of Ross Ulbricht's Testimony]

IN THE LONG RUN, WE'RE ALL DEAD:

DON'T FORGET THE TAXMAN

CRYPTOCURRENCY AND THE TAXMAN

- We have seen how the SEC has aggressively staked out terrain regulating cryptocurrencies as "securities," while the CFTC views them as "commodities" and FinCEN views them as "money" or "currency."
- The IRS, not to be left out of the game, considers cryptocurrencies to be "property" and subject to capital gains tax on disposition.

CRYPTOCURRENCY AND THE TAXMAN

CONSULT A TAX LAWYER

THANK YOU!

DUNNINGTON
BARTHOLOW & MILLER LLP

Private placements - Rule 506(b)

Section 4(a)(2) of the Securities Act exempts from registration transactions by an issuer not involving any public offering.

To learn more about Section 4(a)(2), please click the box below.

Section 4(a)(2)

Rule 506(b) of Regulation D is considered a "safe harbor" under Section 4(a)(2). It provides objective standards that a company can rely on to meet the requirements of the Section 4(a)(2) exemption. Companies conducting an offering under Rule 506(b) can raise an unlimited amount of money and can sell securities to an unlimited number of accredited investors. An offering under Rule 506(b), however, is subject to the following requirements:

- no general solicitation or advertising to market the securities
- securities may not be sold to more than 35 non-accredited investors (all non-accredited investors, either alone or with a purchaser representative, must meet the legal standard of having sufficient knowledge and experience in financial and business matters to be capable of evaluating the merits and risks of the prospective investment)

If non-accredited investors are participating in the offering, the company conducting the offering:

- must give any non-accredited investors disclosure documents that generally contain the same type of information as provided in Regulation A offerings (the company is not required to provide specified disclosure documents to accredited investors, but, if it does provide information to accredited investors, it must also make this information available to the non-accredited investors as well)

- must give any non-accredited investors financial statement information specified in Rule 506 and
- should be available to answer questions from prospective purchasers who are non-accredited investors

Purchasers in a Rule 506(b) offering receive "restricted securities." A company is required to file a notice with the Commission on Form D within 15 days after the first sale of securities in the offering. Although the Securities Act provides a federal preemption from state registration and qualification under Rule 506(b), the states still have authority to require notice filings and collect state fees.

Rule 506(b) offerings are subject to "bad actor" disqualification provisions.

Additional Information and Resources

- Filing a Form D notice
- Compliance Guide: Disqualification of Felons and Other "Bad Actors"
- Staff Guidance: Regulation D Compliance and Disclosure Interpretations (Section 254)
- Investor Bulletin: Private Placements Under Regulation D
- Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2014

Relevant FAQs

- Do the anti-fraud provisions apply?
- What is an accredited investor?
- Do state law requirements apply?
- What are restricted securities?
- What is the process for requesting a waiver of "bad actor" disqualification?

Additional Information and Resources

- Press Release: SEC Harmonizes and Improves “Patchwork” Exempt Offering Framework
- Compliance Guide: Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets
- Filing a Form D notice
- Compliance Guide: Disqualification of Felons and Other “Bad Actors”
- Staff Guidance: Regulation D Compliance and Disclosure Interpretations (Section 254)
- Investor Bulletin: Private Placements Under Regulation D
- Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2017
- Report to Congress on Regulation A / Regulation D Performance

Modified: March 15, 2021

Hedge Funds and Other Private Funds: Reg and Comp Appendix G2

Hedge Funds and Other Private Funds:Regulation and Compliance | December 2020 Update
Thomas P. Lemke, Gerald T. Lins, Kathryn L. Hoenig and Patricia S. Rube

Appendices

Appendix G2. Touche, Remnant & Co., SEC No-Action Letter (pub. avail. Aug. 27, 1984)

(SEC No-Action Letter)

***1 Touche, Remnant & Company**

Publicly Available August 27, 1984

LETTER TO SEC

December 16, 1983
Office of Chief Counsel
Division of Investment Management
Securities and Exchange Commission
Washington, D.C. 20549

Re: Touche, Remnant & Co. (U.K.)
Stein Roe & Farnham

Gentlemen:

We have been requested by Touche, Remnant & Co., an investment advisor organized under and governed by the laws of the United Kingdom ("TR") and Stein Roe & Farnham, an Illinois limited partnership registered under the Investment Advisers Act of 1940 ("SR & F"), to solicit staff concurrence that it would not recommend enforcement action to the Commission based on section 7(d) of the Investment Company Act of 1940 if a non-U.S. investment fund (the "Fund") were operated in the manner proposed below.

Description of TR and SR & F

T.R., a U.K. investment advisor founded in 1889, and its affiliates, operate principally in the United Kingdom and Europe and currently have under management assets in excess of U.S. $3,000,000,000. TR and its affiliates do not maintain any business operations in the United States but it and one of its affiliates do advise one U.S. institution on non-U.S. investments and are registered under the Advisers Act. SF & F operates principally in the United States and currently manages assets in excess of U.S. $8,000,000,000.

Description of the Proposed Fund.

The Fund would be a diversified investment fund currently contemplated to be organized under the laws of the Cayman Islands and having its principal place of business in Nassau, the Bahamas. The Fund would offer three investment tracks: securities of non-U.S. issuers; Eurodollar short-term money market instruments and foreign and U.S. bank certificates of deposit; and U.S. capital growth securities.

The Board of Directors of the Fund would have overall control of the investment and reinvestment of fund assets and would be comprised of an equal number of non-U.S. and U.S. persons. All Board meetings would be held outside the United States. Officers of the Fund will be non-U.S. persons resident in the Bahamas who shall conduct the following functions:

(a) Communicating with shareholders (including the furnishing of financial reports),

(b) Communicating with the general public,

(c) Making redemptions of the Fund's stock,

(d) Accepting the subscriptions of new stockholders,

(e) Maintaining its principal corporate records and books of account,

(f) Auditing the Fund's books of account,

(g) Disbursing payments of dividends, legal fees, accounting fees and officers' and directors' salaries,

(h) Publishing (e.g., London Financial Times, International Herald Tribune) or furnishing the offering and redemption price of the shares of stock issued by the Fund, and

(i) Conducting meetings of shareholders and board of directors.

These functions will be discharged pursuant to contractual arrangements with the Bahamian unit of a major European or other international bank. The physical assets of the Fund consisting of non-U.S. securities would be located in the United Kingdom and other non-U.S. locations and physical assets consisting of U.S. securities would be located in the United States.

***2** The Fund will enter into an advisory and management contract with a management company jointly owned by TR and SR & F and perhaps other non-U.S. investment entities. It is presently contemplated that it will be organized under the laws of the Bahamas. Pursuant to the agreement, the offshore management company will manage the investment and reinvestment of the Fund's assets and advise with respect thereto subject to the overall control of the Board of Directors of the Fund. A TR representative will be a principal officer of the management company with responsibility for overseeing the discharge of the Fund's business functions and approving the recommendations of the Fund's subadvisors as described below. All meetings of the Board of Directors of the management company will be held outside the United States.

The offshore management organization will enter into subadvisory agreements with each of TR and SF & F pursuant to which each will continuously review the investment track or tracks for which it has responsibility and recommend which securities should be purchased and sold by the Fund in those tracks subject to the approval and overall control of the management company and the Board of Directors of the Fund. Advisory fees will be competitive and commensurate with the respective services of each sub-advisor.

The shares will be distributed primarily to non-U.S. investors outside the United States through TR and other non-U.S. dealers which will have sole and complete responsibility for effecting all such sales and will utilize appropriate procedures to assure such distribution comes to rest abroad. Neither TR nor SR & F plans to charge a sales load on sale of Fund shares but foreign dealers in countries where TR and SR & F do not have operations may do so in accordance with schedules or negotiation as described in the Fund's disclosure documents.

As to U.S. investors, the shares will be recommended by SR & F only to its U.S. investor-clients and business associates that are financially sophisticated, accredited investors and will be sold only to such persons so as to assure compliance with the exemptive requirements of SEC Rule 506. U.S. investors at no time will constitute majority ownership of the Fund shares. There may be majority U.S. investor interest within a particular track.

Discussion

Section 7(d) reads in relevant part as follows:

> "No investment company, unless organized or otherwise created under the laws of the United States, … shall make use of the mails or any means or instrumentality of interstate commerce, directly or indirectly, to offer for sale, sell, or deliver after sale, in connection with a public offering, any security of which such company is the issuer. … " (Emphasis added.)

As previously stated, it is presently contemplated that the Fund would be incorporated under the laws of the Cayman Islands and discharge its principal business functions in Nassau, the Bahamas. As also previously stated, however, the Fund will not be making a public offering in the United States but rather a private placement meeting all exemptive requirements of Rule 506 of Regulation D.

***3** We believe the prohibition against public share offerings by unregistered foreign investment companies, in the circumstances described herein, is not applicable where sales are restricted to accredited investors pursuant to Rule 506. In this connection, recommendation of the Fund shares to financially sophisticated, accredited investor/clients and business associates of SR & F will not constitute a "general solicitation" under the standards articulated by the Corporation Finance staff in Woodtrails-Seattle, Ltd. (August 9, 1982). Specifically each offeree will have a pre-existing business relationship with SR & F that was established or continued within three years prior to the offer and SR & F will have reasonable grounds to believe that the offeree is and will be either an accredited investor or has and will have such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment both at the time the relationship was established and at the time of the offer. The Investment Management staff noted in San Jose Capital Corporation (February 14, 1983) and Continental Bank (September 3, 1982) that this standard is a condition of Rule 506 and, therefore, assuming the other conditions of Rule 506 are met, that Rule 506 will not be deemed to involve any public offering. [1]

The San Jose Capital Corporation and Continental Bank no-action responses accept and are consistent with the position of the Commission that Rule 506 transactions are "non-public offerings for the purposes of the definition of 'investment company' in Section 3(c)(1) of the Investment Company Act." (33- 6389, n. 33). Moreover, in Ideal Mortgage and Realty Service Corporation (January 4, 1978), the staff stated that an offering meeting all the conditions of Rule 146, a predecessor rule to Regulation D, would not be a public offering for purposes of section 3(c)(1) of the 1940 Act and in Mitchell (July 24, 1975) the staff similarly concluded that a Rule 146 transaction would not be a public offering for purposes of Section 7(d). While we are not relying on Section 3(c)(1) as the basis for this no-action request, we believe the Commission's interpretation of the term "public offering" in Section 3(c)(1) should have, logically and consistently, the same application to the same term in a companion provision of the same Act, i.e., Section 7(d).

In reaching this conclusion, we are aware that the Investment Management staff in Mitchell, mentioned above, went on to state that if the investment company's private offering in the United States were coincident with an offering of its securities abroad, traditional Securities Act concepts of "integration" might become relevant and could affect the "private offering" status under

Section 7(d). These "traditional" integration concepts are set forth in a 1964 Commission release (33-4708) which takes the position that so long as an offering to foreign nationals abroad is made under circumstances reasonably designed to preclude distribution or redistribution of the securities within, or to nationals of, the United States, then a private placement in the United States need not be integrated with simultaneous offerings made abroad. [2] As has been previously stated, TR, the U.K. investment advisor, and other non- U.S. dealers will have sole responsibility for effecting sales to foreign nationals abroad under procedures designed to assure that the offerings come to rest abroad. See, for example, the procedures discussed in Sears Overseas Finance N.V. (June 11, 1982). As a practical matter, since the Fund would be an open-end fund redeeming its shares in Nassau, it is highly unlikely in any event that shares sold abroad would flow into the hands of U.S. investors or that a secondary market would develop in the United States.

***4** While we believe the foregoing is dispositive of the integration issue, we further suggest the appropriateness of applying the integration concept in a Section 7(d) context is questionable. Its application seems to suggest the validity of broadly construing the term public offering to mean a worldwide offering—even where the non-U.S. part clearly comes to rest abroad—rather than one limited to the United States. Although the phrase "in the United States" does not follow the words "public offering" in Section 7(d), we believe that such limitation is necessarily implicit by the clear domestic purport of the section itself. Lest there be any doubt on the point, the legislative history is clear and unambiguous as summarized in Exhibit A hereto.

We further note in this regard that Rule 501(e) excludes investors who are neither citizens nor residents of the United States from the calculation of the number of purchasers in offerings under Rule 506. While we do not rely on this exclusion for foreign investors, we believe it clearly supportive of the position taken. It also seems to us that the Investment Management staff and the Commission have sanctioned U.S. investor interests in foreign funds under Section 7(d) where there is no public offering in the United States. The London Life Association (April 27, 1979); American European Securities Company, ICA Rel. No. 7172 (May 10, 1972).

Finally, we note that in Shearson International Dollar Reserves (July 15, 1981), the staff identified as a factor in the Section 7(d) analysis whether the "most significant and essential functions" of the foreign fund are being performed in the United States. As we trust is clear from our factual recitation herein, the principal business functions of the Fund would be performed in Nassau by non-U.S. persons. This is not a situation where the most significant functions will be performed in the U.S. by U.S. persons only. Both the U.K. investment advisor and SR & F will have significant responsibilities with respect to portfolio recommendations to the foreign Fund and will jointly exercise overall control with SR & F at the Nassau and U.K. Board meetings outside the U.S.

Conclusion

Based on the foregoing, we respectfully request that you confirm our opinion that (i) a private placement in the United States meeting all exemptive requirements of Rule 506 is not a "public offering" for purposes of Section 7(d); (ii) the principles articulated by the Commission in the 1964 integration release are applicable to the proposed placement in the U.S. and the offering abroad; and (iii) the staff will not recommend enforcement action to the Commission under section 7(d) if the Fund conducts its operations in the manner described herein.

In the event you are unable to concur in our view, we request you contact the undersigned before sending a reply.

In accordance with Release 33-6269, we enclose seven copies of this request.

Very truly yours,
***5** BAKER & McKENZIE
By Robert J. Gareis

LETTER TO SEC

April 26, 1984

Office of Chief Counsel
Division of Investment Management
Securities and Exchange Commission
Washington, D.C. 20549

Re: Touche Remnant & Co. (U.K.)
Stein Roe & Farnham

Gentlemen:

We have been requested by Stein Roe & Farnham to advise you that the proposed Fund intends to conduct its operations so that the number of U.S. beneficial owners of Fund shares would not exceed more than one hundred U.S. persons. Restrictive legends on Fund shares issued to U.S. purchasers would contain provisions (in addition to conventional 1933 Act restrictions on resales) requiring certificates of non-U.S. citizenship from transferees and prohibiting sales, transfers or assignments (other than by will or the laws of descent and distribution) if the effect thereof would increase the number of U.S. persons beneficially holding shares of the fund, directly or indirectly, to more than one hundred persons. The number will be determined by reference to the stock records maintained by or on behalf of the Fund. "U.S. person" for this purpose shall mean a citizen, national or resident of, or a corporation or partnership created or organized in, the United States of America. We note in this regard that it is our opinion that such limitation is not legally mandated by Section 7(d) of the Act.

Very truly yours,
Baker & McKenzie
By Robert J. Gareis

SEC LETTER

1940 Act / s 7(d)
1940 Act / s3(c)(1)
July 27, 1984
Publicly Available August 27, 1984
Our Ref. No. 83-436-CC
Touche Remnant & Co; Stein,
Roe & Farnham
File No. 132-3

This responds to your letter of December 16, 1983, and supplementary letter of April 26, 1984, regarding the applicability of the Investment Company Act of 1940 (1940 Act) to the sale in the United States (U.S.) of shares of an unregistered "foreign investment company", i.e., an investment company organized under the laws of and having its principal place of business in a country other than the U.S. and not registered under the 1940 Act. The question you raised was whether a foreign investment company not registered under the 1940 Act could legally make a "private offering" in the U.S. pursuant to rule 506 of Regulation D of the Securities Act of 1933 ("Securities Act"), coincident with a public offering of the company's shares abroad, without violating section 7(d) of the 1940 Act.

In our view, a foreign investment company operating abroad which uses jurisdictional means to make an offering in the U.S. which would comply with all of the requirements of a private placement under rule 506 of Regulation D, including the limitations on resale and transfer found in rule 502(d) of Regulation D, would be subject to the 1940 Act if upon completion of the offering there would be more than 100 persons resident in the U.S. who were beneficial owners of its securities. This is not because the foreign investment company is offering its shares both in the U.S. and abroad. America's jurisdictional interest in a company is based on its specific activities in the U.S. or the effects in the U.S. of its activities conducted abroad.

***6** Section 3(c)(1) of the 1940 Act excepts from the definition of investment company any issuer whose outstanding securities are beneficially owned by not more than one hundred persons and which is not making a public offering of its securities (emphasis added). Thus, section 3(c)(1) indicates a regulatory interest under the 1940 Act in an investment company whose securities are beneficially owned by more than 100 persons. [3]

It is quite clear that a U.S. investment company with more than 100 beneficial owners is required to register under and comply with all provisions of the 1940 Act regardless of whether the company is making or proposing to make a public offer of its securities. Section 7(d) demonstrates Congress' intent to require foreign investment companies whose conduct has a significant effect on U.S. investors to be subject to the same type of regulation that applies to American investment companies. [4] Reading section 7(d) in the light of that policy, and the policy expressed in section 3(c)(1), we conclude that where a foreign investment company uses jurisdictional means in connection with an offer of its securities to U.S. residents, which offer results in the company having more than 100 beneficial owners resident in the U.S., such a company may not sell its securities to U.S. residents without fully complying with the 1940 Act. If section 7(d) were not interpreted in this manner, U.S. investment companies with more than 100 beneficial owners would be subject to regulation under the 1940 Act while foreign investment companies with more than 100 beneficial owners resident in the U.S. would not be so regulated. We believe such a result would be contrary to the policy expressed in section 7(d).

In order to properly account for all owners when planning an offer, an issuer should ascertain the number of pre-existing U.S. resident owners, if any, prior to initiating an offering. For purposes of counting beneficial owners, the rules of attribution found in section 3(c)(1) generally would apply. [5] In addition, where a company is organized for the purpose of investing in the securities of one or more unregistered, foreign investment companies, the beneficial owners of that company's securities would be counted as beneficial owners of the securities of the foreign investment company. [6]

***7** This letter, of course, addresses only the staff's views as to certain issues raised under the 1940 Act and not those that might be raised under any other laws administered by the Commission.

Judith W. Axe
Attorney
Securities and Exchange Commission (S.E.C.)

Footnotes

1 *See also* Santa Barbara Securities (April 8, 1983) and Asset Allocation Incorporated (August 16, 1983). We also note that the exemption afforded by Rules 504 and 505 are not available to offerings by investment companies unless excepted from the definition thereof by section 3 of the 1940 Act. James F. Basque Esq. (October 20, 1982), San Jose Capital Corporation, supra. Rule 506, however, is available to any investment company.

2 The Commission's 1970 guidelines (33-5068) require 1933 Act registration for foreign sales by registered open-end U.S. investment companies. The rationale stated in the release for this position is that these companies are continually in registration so that 1933 Act registration would not impose an additional burden on them. We do not disagree with this policy but point out that neither the facts nor the rationale apply here.

3 Companies with more than 100 beneficial owners at the time the 1940 Act became effective were required to register under the 1940 Act whether or not they planned to offer additional shares.

4 It is the purpose of section 7(d) that "foreign investment companies may not register as investment companies or publicly offer securities of which they are the issuer in the United States unless the Commission finds that these foreign investment companies can be effectively subjected to the same type

of regulation as domestic investment companies." S.Rep. No. 1775, 76th Cong., 3d Sess. 13 (1940); H.R.Rep. No. 2639, 76th Cong., 3d Sess. 13 (1940).

5 In particular, Section 3(c)(1)(A) of the Act states that:

> Beneficial ownership by a company shall be deemed to be beneficial ownership by one person, except that, if such company owns 10 per centum or more of the outstanding voting securities of the issuer, the beneficial ownership shall be deemed to be that of the holders of such company's outstanding securities (other than short-term paper) unless, as of the date of the most recent acquisition by such company of securities of that issuer, the value of all securities owned by such company of all issuers which are or would, but for the exception set forth in this subparagraph, be excluded from the definition of investment company solely by this paragraph, does not exceed 10 percentum of the value of the company's total assets (emphasis added).

Section 2(a)(8) of the Act defines the term "company" to include a corporation, a partnership, and various other specified individuals, groups, and entities.

6 Section 48(a) of the 1940 Act prohibits a person from doing indirectly that which he could not legally do directly. *Cf.* rule 501(e)(2) under the Securities Act stating how the number of purchasers is calculated for purposes of Regulation D when an entity is created for the specific purpose of acquiring the securities offered.

End of Document

15 U.S. Code § 80a–2 - Definitions; applicability; rulemaking considerations

(a) Definitions

When used in this subchapter, unless the context otherwise requires —

(1) "Advisory board" means a board, whether elected or appointed, which is distinct from the board of directors or board of trustees, of an investment company, and which is composed solely of persons who do not serve such company in any other capacity, whether or not the functions of such board are such as to render its members "directors" within the definition of that term, which board has advisory functions as to investments but has no power to determine that any security or other investment shall be purchased or sold by such company.

(2) "Affiliated company" means a company which is an affiliated person.

(3) "Affiliated person" of another person means (A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof.

(4) "Assignment" includes any direct or indirect transfer or hypothecation of a contract or chose in action by the assignor, or of a controlling block of the assignor's outstanding voting securities by a security holder of the assignor; but does not include an assignment of partnership interests incidental to the death or withdrawal of a minority of the members of the partnership having only a minority interest in the partnership business or to the admission to the partnership of one or more members who, after such admission, shall be only a minority of the members and shall have only a minority interest in the business.

(5) "Bank" means (A) a depository institution (as defined in section 1813 of title 12) or a branch or agency of a foreign bank (as such terms are defined in section 3101 of title 12), (B) a member bank of the Federal Reserve System, (C) any other banking institution or trust company, whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency, and which is supervised and examined by State or Federal authority having supervision over banks, and which is not operated for the purpose of evading the provisions of this subchapter, and (D) a receiver, conservator, or other liquidating agent of any institution or firm included in clauses (A), (B), or (C) of this paragraph.

(6) The term "broker" has the same meaning as given in section 3 of the Securities Exchange Act of 1934 [15 U.S.C. 78c], except that such term does not include any person solely by reason of the fact that such person is an underwriter for one or more investment companies.

(7) "Commission" means the Securities and Exchange Commission.

(8) "Company" means a corporation, a partnership, an association, a joint-stock company, a trust, a fund, or any organized group of persons whether incorporated or not; or any receiver, trustee in a case under title 11 or similar official or any liquidating agent for any of the foregoing, in his capacity as such.

(9) "Control" means the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company. Any person who owns beneficially, either directly or through one or more controlled companies, more than 25 per centum of the voting securities of a company shall be presumed to control such company. Any person who does not so own more than 25 per centum of the voting securities of any company shall be presumed not to control such company. A natural person shall be presumed not to be a controlled person within the meaning of this subchapter. Any such presumption may be rebutted by evidence, but except as hereinafter provided, shall continue until a determination to the contrary made by the Commission by order either on its own motion or on application by an interested person. If an application filed hereunder is not granted or denied by the Commission within sixty days after filing thereof, the determination sought by the application shall be deemed to have been temporarily granted pending final determination of the Commission thereon. The Commission, upon its own motion or upon application, may by order revoke or modify any order issued under this paragraph whenever it shall find that the determination embraced in such original order is no longer consistent with the facts.

(10) "Convicted" includes a verdict, judgment, or plea of guilty, or a finding of guilt on a plea of nolo contendere, if such verdict, judgment, plea, or finding has not been reversed, set aside, or withdrawn, whether or not sentence has been imposed.

(11) The term "dealer" has the same meaning as given in the Securities Exchange Act of 1934 [15 U.S.C. 78a et seq.], but does not include an insurance company or investment company.

(12) "Director" means any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated, including any natural person who is a member of a board of trustees of a management company created as a common-law trust.

(13) "Employees' securities company" means any investment company or similar issuer all of the outstanding securities of which (other than short-term paper) are beneficially owned (A) by the employees or persons on retainer of a single employer or of two or more employers each of which is an affiliated company of the other, (B) by former employees of such employer or employers, (C) by members of the immediate family of such employees, persons on retainer, or former employees, (D) by any two or more of the foregoing classes of persons, or (E) by such employer or employers together with any one or more of the foregoing classes of persons.

(14) "Exchange" means any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood, and includes the market place and the market facilities maintained by such exchange.

(15) "Face-amount certificate" means any certificate, investment contract, or other security which represents an obligation on the part of its issuer to pay a stated or determinable sum or sums at a fixed or determinable date or dates more than twenty-four months after the date of issuance, in consideration of the payment of periodic installments of a stated or determinable amount (which security shall be known as a face-amount certificate of the "installment type"); or any security which represents a similar obligation on the part of a face-amount certificate company, the consideration for which is the payment of a single lump sum (which security shall be known as a "fully paid" face-amount certificate).

(16) "Government security" means any security issued or guaranteed as to principal or interest by the United States, or by a person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States; or any certificate of deposit for any of the foregoing.

(17) "Insurance company" means a company which is organized as an insurance company, whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies, and which is subject to supervision by the insurance commissioner or a similar official or agency of a State; or any receiver or similar official or any liquidating agent for such a company, in his capacity as such.

(18) "Interstate commerce" means trade, commerce, transportation, or communication among the several States, or between any foreign country and any State, or between any State and any place or ship outside thereof.

(19) "Interested person" of another person means—

(A) when used with respect to an investment company—

(i) any affiliated person of such company,

(ii) any member of the immediate family of any natural person who is an affiliated person of such company,

(iii) any interested person of any investment adviser of or principal underwriter for such company,

(iv) any person or partner or employee of any person who at any time since the beginning of the last two completed fiscal years of such company has acted as legal counsel for such company,

(v) any person or any affiliated person of a person (other than a registered investment company) that, at any time during the 6-month period preceding the date of the determination of whether that person or affiliated person is an interested person, has executed any portfolio transactions for, engaged in any principal transactions with, or distributed shares for—

(I) the investment company;

(II) any other investment company having the same investment adviser as such investment company or holding itself out to investors as a related company for purposes of investment or investor services; or

(III) any account over which the investment company's investment adviser has brokerage placement discretion,

(vi) any person or any affiliated person of a person (other than a registered investment company) that, at any time during the 6-month period preceding the date of the determination of whether that person or affiliated person is an interested person, has loaned money or other property to—

(I) the investment company;

(II) any other investment company having the same investment adviser as such investment company or holding itself out to investors as a related company for purposes of investment or investor services; or

(III) any account for which the investment company's investment adviser has borrowing authority, and

(vii) any natural person whom the Commission by order shall have determined to be an interested person by reason of having had, at any time since the beginning of the last two completed fiscal years of such company, a material business or professional relationship with such company or with the principal executive officer of such company or with any other investment company having the same investment adviser or principal underwriter or with the principal executive officer of such other investment company:

Provided, That no person shall be deemed to be an interested person of an investment company solely by reason of (aa) his being a member of its board of directors or advisory board or an owner of its securities, or (bb) his membership in the immediate family of any person specified in clause (aa) of this proviso; and

(B) when used with respect to an investment adviser of or principal underwriter for any investment company—

(i) any affiliated person of such investment adviser or principal underwriter,

(ii) any member of the immediate family of any natural person who is an affiliated person of such investment adviser or principal underwriter,

(iii) any person who knowingly has any direct or indirect beneficial interest in, or who is designated as trustee, executor, or guardian of any legal interest in, any security issued either by such investment adviser of principal underwriter or by a controlling person or such investment adviser or principal underwriter,

(iv) any person or partner or employee of any person who at any time since the beginning of the last two completed fiscal years of such investment company has acted as legal counsel for such investment adviser or principal underwriter,

(v) any person or any affiliated person of a person (other than a registered investment company) that, at any time during the 6-month period preceding the date of the determination of whether that person or affiliated person is an interested person, has executed any portfolio transactions for, engaged in any principal transactions with, or distributed shares for—

(I) any investment company for which the investment adviser or principal underwriter serves as such;

(II) any investment company holding itself out to investors, for purposes of investment or investor services, as a company related to any investment company for which the investment adviser or principal underwriter serves as such; or

(III) any account over which the investment adviser has brokerage placement discretion,

(vi) any person or any affiliated person of a person (other than a registered investment company) that, at any time during the 6-month period preceding the date of the determination of whether that person or affiliated person is an interested person, has loaned money or other property to—

(I) any investment company for which the investment adviser or principal underwriter serves as such;

(II) any investment company holding itself out to investors, for purposes of investment or investor services, as a company related to any investment company for which the investment adviser or principal underwriter serves as such; or

(III) any account for which the investment adviser has borrowing authority, and

(vii) any natural person whom the Commission by order shall have determined to be an interested person by reason of having had at any time since the beginning of the last two completed fiscal years of such investment company a material business or professional relationship with such investment adviser or principal underwriter or with the principal executive officer or any controlling person of such investment adviser or principal underwriter.

For the purposes of this paragraph (19), "member of the immediate family" means any parent, spouse of a parent, child, spouse of a child, spouse, brother, or sister, and includes step and adoptive relationships. The Commission may modify or revoke any order issued under clause (vii) of subparagraph (A) or (B) of this paragraph whenever it finds that such order is no longer consistent with the facts. No order issued pursuant to clause (vii) of subparagraph (A) or (B) of this paragraph shall become effective until at least sixty days after the entry thereof, and no such order shall affect the status of any person for the purposes of this subchapter or for any other purpose for any period prior to the effective date of such order.

(20) "Investment adviser" of an investment company means (A) any person (other than a bona fide officer, director, trustee, member of an advisory board, or employee of such company, as such) who pursuant to contract with such company regularly furnishes advice to such company with respect to the desirability of investing in, purchasing or selling securities or other property, or is empowered to determine what securities or other property shall be purchased or sold by such company, and (B) any other person who pursuant to contract with a person described in clause (A) of this paragraph regularly performs substantially all of the duties undertaken by such person described in said clause (A); but does not include (i) a person whose advice is furnished solely through uniform publications distributed to subscribers thereto, (ii) a person who furnishes only statistical and other factual information, advice regarding economic factors and trends, or advice as to occasional transactions in specific securities, but without generally furnishing advice or making recommendations regarding the purchase or sale of securities, (iii) a company furnishing such services at cost to one or more investment companies, insurance companies, or other financial institutions, (iv) any person the character and amount of whose compensation for such services must be approved by a court, or (v) such other persons as the Commission may by rules and regulations or order determine not to be within the intent of this definition.

(21) "Investment banker" means any person engaged in the business of underwriting securities issued by other persons, but does not include an investment company, any person who acts as an underwriter in isolated transactions but not as a part of a regular business, or any person solely by reason of the fact that such person is an underwriter for one or more investment companies.

(22) "Issuer" means every person who issues or proposes to issue any security, or has outstanding any security which it has issued.

(23) "Lend" includes a purchase coupled with an agreement by the vendor to repurchase; "borrow" includes a sale coupled with a similar agreement.

(24) "Majority-owned subsidiary" of a person means a company 50 per centum or more of the outstanding voting securities of which are owned by such person, or by a company which, within the meaning of this paragraph, is a majority-owned subsidiary of such person.

(25) "Means or instrumentality of interstate commerce" includes any facility of a national securities exchange.

(26) "National securities exchange" means an exchange registered under section 6 of the Securities Exchange Act of 1934 [15 U.S.C. 78f].

(27) "Periodic payment plan certificate" means (A) any certificate, investment contract, or other security providing for a series of periodic payments by the holder, and representing an undivided interest in certain specified securities or in a unit or fund of securities purchased wholly or partly with the proceeds of such payments, and (B) any security the issuer of which is also issuing securities of the character described in clause (A) of this paragraph and the holder of which has substantially the same rights and privileges as those which holders of securities of the character described in said clause (A) have upon completing the periodic payments for which such securities provide.

(28) "Person" means a natural person or a company.

(29) "Principal underwriter" of or for any investment company other than a closed-end company, or of any security issued by such a company, means any underwriter who as principal purchases from such company, or pursuant to contract has the right (whether absolute or conditional) from time to time to purchase from such company, any such security for distribution, or who as agent for such company sells or has the right to sell any such security to a dealer or to the public or both, but does not include a dealer who purchases from such company through a principal underwriter acting as agent for such company. "Principal underwriter" of or for a closed-end company or any issuer which is not an investment company, or of any security issued by such a company or issuer, means any underwriter who, in connection with a primary distribution of securities, (A) is in privity of contract with the issuer or an affiliated person of the issuer; (B) acting alone or in concert with one or more other persons, initiates or directs the formation of an underwriting syndicate; or (C) is allowed a rate of gross commission, spread, or other profit greater than the rate allowed another underwriter participating in the distribution.

(30) "Promoter" of a company or a proposed company means a person who, acting alone or in concert with other persons, is initiating or directing, or has within one year initiated or directed, the organization of such company.

(31) "Prospectus", as used in section 80a–22 of this title, means a written prospectus intended to meet the requirements of section 10(a) of the Securities Act of 1933 [15 U.S.C. 77j(a)] and currently in use. As used elsewhere, "prospectus" means a prospectus as defined in the Securities Act of 1933 [15 U.S.C. 77a et seq.].

(32) "Redeemable security" means any security, other than short-term paper, under the terms of which the holder, upon its presentation to the issuer or to a person designated by the issuer, is entitled (whether absolutely or only out of surplus) to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof.

(33) "Reorganization" means (A) a reorganization under the supervision of a court of competent jurisdiction; (B) a merger or consolidation; (C) a sale of 75 per centum or more in value of the assets of a company; (D) a restatement of the capital of a company, or an exchange of securities issued by a company for any of its own outstanding securities; (E) a voluntary dissolution or liquidation of a company; (F) a recapitalization or other procedure or transaction which has for its purpose the alteration, modification, or elimination of any of the rights, preferences, or privileges of any class of securities issued by a company, as provided in its charter or other instrument creating or defining such rights, preferences, and privileges; (G) an exchange of securities issued by a company for outstanding securities issued by another company or companies, preliminary to and for the purpose of effecting or consummating any of the foregoing; or (H) any exchange of securities by a company which is not an investment company for securities issued by a registered investment company.

(34) "Sale", "sell", "offer to sell", or "offer for sale" includes every contract of sale or disposition of, attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value. Any security given or delivered with, or as a bonus on account of, any purchase of securities or any other thing, shall be conclusively presumed to constitute a part of the subject of such purchase and to have been sold for value.

(35) "Sales load" means the difference between the price of a security to the public and that portion of the proceeds from its sale which is received and invested or held for investment by the issuer (or in the case of a unit investment trust, by the depositor or trustee), less any portion of such difference deducted for trustee's or custodian's fees, insurance premiums, issue taxes, or administrative expenses or fees which are not properly chargeable to sales or promotional activities. In the case of a periodic payment plan certificate, "sales load" includes the sales load on any investment company securities in which the payments made on such certificate are invested, as well as the sales load on the certificate itself.

(36) "Security" means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

(37) "Separate account" means an account established and maintained by an insurance company pursuant to the laws of any State or territory of the United States, or of Canada or any province thereof, under which income, gains and losses, whether or not realized, from assets allocated to such account, are, in accordance with the applicable contract, credited to or charged against such account without regard to other income, gains, or losses of the insurance company.

(38) "Short-term paper" means any note, draft, bill of exchange, or banker's acceptance payable on demand or having a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof payable on demand or having a maturity likewise limited; and such other classes of securities, of a commercial rather than an investment character, as the Commission may designate by rules and regulations.

(39) "State" means any State of the United States, the District of Columbia, Puerto Rico, the Virgin Islands, or any other possession of the United States.

(40) "Underwriter" means any person who has purchased from an issuer with a view to, or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributor's or seller's commission. As used in this paragraph the term "issuer" shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer. When the distribution of the securities in respect of which any person is an underwriter is completed such person shall cease to be an underwriter in respect of such securities or the issuer thereof.

(41) "Value", with respect to assets of registered investment companies, except as provided in subsection (b) of section 80a–28 of this title, means—

(A) as used in sections 80a–3, 80a–5, and 80a–12 of this title, (i) with respect to securities owned at the end of the last preceding fiscal quarter for which market quotations are readily available, the market value at the end of such quarter; (ii) with respect to other securities and assets owned at the end of the last preceding fiscal quarter, fair value at the end of such quarter, as determined in good faith by the board of directors; and (iii) with respect to securities and other assets acquired after the end of the last preceding fiscal quarter, the cost thereof; and

(B) as used elsewhere in this subchapter, (i) with respect to securities for which market quotations are readily available, the market value of such securities; and (ii) with respect to other securities and assets, fair value as determined in good faith by the board of directors;

in each case as of such time or times as determined pursuant to this subchapter, and the rules and regulations issued by the Commission hereunder. Notwithstanding the fact that market quotations for securities issued by controlled companies are available, the board of directors may in good faith determine the value of such securities: *Provided*, That the value so determined is not in excess of the higher of market value or asset value of such securities in the case of majority-owned subsidiaries, and is not in excess of market value in the case of other controlled companies.

For purposes of the valuation of those assets of a registered diversified company which are not subject to the limitations provided for in section 80a–5(b)(1) of this title, the Commission may, by rules and regulations or orders, permit any security to be carried at cost, if it shall determine that such procedure is consistent with the general intent and purposes of this subchapter. For purposes of sections 80a–5 and 80a–12 of this title in lieu of values determined as provided in clause (A) above, the Commission shall by rules and regulations permit valuation of securities at cost or other basis in cases where it may be more convenient for such company to make its computations on such basis by reason of the necessity or desirability of complying with the provisions of any United States revenue laws or rules and regulations issued thereunder, or the laws or the rules and regulations issued thereunder of any State in which the securities of such company may be qualified for sale.

The foregoing definition shall not derogate from the authority of the Commission with respect to the reports, information, and documents to be filed with the Commission by any registered company, or with respect to the accounting policies and principles to be followed by any such company, as provided in sections 80a–8, 80a–29, and 80a–30 of this title.

(42) "Voting security" means any security presently entitling the owner or holder thereof to vote for the election of directors of a company. A specified percentage of the outstanding voting securities of a company means such amount of its outstanding voting securities as entitles the holder or holders thereof to cast said specified percentage of the aggregate votes which the holders of all the outstanding voting securities of such company are entitled to cast. The vote of a majority of the outstanding voting securities of a company means the vote, at the annual or a special meeting of the security holders of such company duly called, (A) of 67 per centum or more of the voting securities present at such meeting, if the holders of more than 50 per centum of the outstanding voting securities of such company are present or represented by proxy; or (B) of more than 50 per centum of the outstanding voting securities of such company, whichever is the less.

(43) "Wholly-owned subsidiary" of a person means a company 95 per centum or more of the outstanding voting securities of which are owned by such person, or by a company which, within the meaning of this paragraph, is a wholly-owned subsidiary of such person.

(44) "Securities Act of 1933" [15 U.S.C. 77a et seq.], "Securities Exchange Act of 1934" [15 U.S.C. 78a et seq.], and "Trust Indenture Act of 1939" [15 U.S.C. 77aaa et seq.] mean those acts, respectively, as heretofore or hereafter amended.

(45) "Savings and loan association" means a savings and loan association, building and loan association, cooperative bank, homestead association, or similar institution, which is supervised and examined by State or Federal authority having supervision over any such institution, and a receiver, conservator, or other liquidating agent of any such institution.

(46) "Eligible portfolio company" means any issuer which—

(A) is organized under the laws of, and has its principal place of business in, any State or States;

(B) is neither an investment company as defined in section 80a–3 of this title (other than a small business investment company which is licensed by the Small Business Administration to operate under the Small Business Investment Act of 1958 [15 U.S.C. 661 et seq.] and which is a wholly-owned subsidiary of the business development company) nor a company which would be an investment company except for the exclusion from the definition of investment company in section 80a–3(c) of this title; and

(C) satisfies one of the following:

(i) it does not have any class of securities with respect to which a member of a national securities exchange, broker, or dealer may extend or maintain credit to or for a customer pursuant to rules or regulations adopted by the Board of Governors of the Federal Reserve System under section 7 of the Securities Exchange Act of 1934 [15 U.S.C. 78g];

(ii) it is controlled by a business development company, either alone or as part of a group acting together, and such business development company in fact exercises a controlling influence over the management or policies of such eligible portfolio company and, as a result of such control, has an affiliated person who is a director of such eligible portfolio company;

(iii) it has total assets of not more than $4,000,000, and capital and surplus (shareholders' equity less retained earnings) of not less than $2,000,000, except that the Commission may adjust such amounts by rule, regulation, or order to reflect changes in 1 or more generally accepted indices or other indicators for small businesses; or

(iv) it meets such other criteria as the Commission may, by rule, establish as consistent with the public interest, the protection of investors, and the purposes fairly intended by the policy and provisions of this subchapter.

(47) "Making available significant managerial assistance" by a business development company means—

(A) any arrangement whereby a business development company, through its directors, officers, employees, or general partners, offers to provide, and, if accepted, does so provide, significant guidance and counsel concerning the management, operations, or business objectives and policies of a portfolio company;

(B) the exercise by a business development company of a controlling influence over the management or policies of a portfolio company by the business development company acting individually or as part of a group acting together which controls such portfolio company; or

(C) with respect to a small business investment company licensed by the Small Business Administration to operate under the Small Business Investment Act of 1958 [15 U.S.C. 661 et seq.], the making of loans to a portfolio company.

For purposes of subparagraph (A), the requirement that a business development company make available significant managerial assistance shall be deemed to be satisfied with respect to any particular portfolio company where the business development company purchases securities of such portfolio company in conjunction with one or more other persons acting together, and at least one of the persons in the group makes available significant managerial assistance to such portfolio company, except that such requirement will not be deemed to be satisfied if the business development company, in all cases, makes available significant managerial assistance solely in the manner described in this sentence.

(48) "Business development company" means any closed-end company which—

(A) is organized under the laws of, and has its principal place of business in, any State or States;

(B) is operated for the purpose of making investments in securities described in paragraphs (1) through (3) of section 80a–54(a) of this title, and makes available significant managerial assistance with respect to the issuers of such securities, provided that a business development company must make available significant managerial assistance only with respect to the companies which are treated by such business development company as satisfying the 70 per centum of the value of its total assets condition of section 80a–54 of this title; and provided further that a business development company need not make available significant managerial assistance with respect to any company described in paragraph (46)(C)(iii), or with respect to any other company that meets such criteria as the Commission may by rule, regulation, or order permit, as consistent with the public interest, the protection of investors, and the purposes of this subchapter; and

(C) has elected pursuant to section 80a–53(a) of this title to be subject to the provisions of sections 80a–54 through 80a–64 of this title.

(49) "Foreign securities authority" means any foreign government or any governmental body or regulatory organization empowered by a foreign government to administer or enforce its laws as they relate to securities matters.

(50) "Foreign financial regulatory authority" means any (A) foreign securities authority, (B) other governmental body or foreign equivalent of a self-regulatory organization empowered by a foreign government to administer or enforce its laws relating to the regulation of fiduciaries, trusts, commercial lending, insurance, trading in contracts of sale of a commodity for future delivery, or other instruments traded on or subject to the rules of a contract market, board of trade or foreign equivalent, or other financial activities, or (C) membership organization a function of which is to regulate the participation of its members in activities listed above.

(51)

(A) "Qualified purchaser" means—

(i) any natural person (including any person who holds a joint, community property, or other similar shared ownership interest in an issuer that is excepted under section 80a–3(c)(7) of this title with that person's qualified purchaser spouse) who owns not less than $5,000,000 in investments, as defined by the Commission;

(ii) any company that owns not less than $5,000,000 in investments and that is owned directly or indirectly by or for 2 or more natural persons who are related as siblings or spouse (including former spouses), or direct lineal descendants by birth or adoption, spouses of such persons, the estates of such persons, or foundations, charitable organizations, or trusts established by or for the benefit of such persons;

(iii) any trust that is not covered by clause (ii) and that was not formed for the specific purpose of acquiring the securities offered, as to which the trustee or other person authorized to make decisions with respect to the trust, and each settlor or other person who has contributed assets to the trust, is a person described in clause (i), (ii), or (iv); or

(iv) any person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than $25,000,000 in investments.

(B) The Commission may adopt such rules and regulations applicable to the persons and trusts specified in clauses (i) through (iv) of subparagraph (A) as it determines are necessary or appropriate in the public interest or for the protection of investors.

(C) The term "qualified purchaser" does not include a company that, but for the exceptions provided for in paragraph (1) or (7) of section 80a–3(c) of this title, would be an investment company (hereafter in this paragraph referred to as an "excepted investment company"), unless all beneficial owners of its outstanding securities (other than short-term paper), determined in accordance with section 80a–3(c)(1)(A) of this title, that acquired such securities on or before April 30, 1996 (hereafter in this paragraph referred to as "pre-amendment beneficial owners"), and all pre-amendment beneficial owners of the outstanding securities (other than short-term paper) of any excepted investment company that, directly or indirectly, owns any outstanding securities of such excepted investment company, have consented to its treatment as a qualified purchaser. Unanimous consent of all trustees, directors, or general partners of a company or trust referred to in clause (ii) or (iii) of subparagraph (A) shall constitute consent for purposes of this subparagraph.

(52) The terms "security future" and "narrow-based security index" have the same meanings as provided in section 3(a)(55) of the Securities Exchange Act of 1934 [15 U.S.C. 78c(a)(55)].

(53) The term "credit rating agency" has the same meaning as in section 3 of the Securities Exchange Act of 1934 [15 U.S.C. 78c].

(54) The terms "commodity pool", "commodity pool operator", "commodity trading advisor", "major swap participant", "swap", "swap dealer", and "swap execution facility" have the same meanings as in section 1a of title 7.

(b) Applicability to government

No provision in this subchapter shall apply to, or be deemed to include, the United States, a State, or any political subdivision of a State, or any agency, authority, or instrumentality of any one or more of the foregoing, or any corporation which is wholly owned directly or indirectly by any one or more of the foregoing, or any officer, agent, or employee of any of the foregoing acting as such in the course of his official duty, unless such provision makes specific reference thereto.

(c) Consideration of promotion of efficiency, competition, and capital formation

Whenever pursuant to this subchapter the Commission is engaged in rulemaking and is required to consider or determine whether an action is consistent with the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

(Aug. 22, 1940, ch. 686, title I, § 2, 54 Stat. 790; Proc. No. 2695, eff. July 4, 1946, 11 F.R. 7517, 60 Stat. 1352; Aug. 10, 1954, ch. 667, title IV, § 401, 68 Stat. 688; Pub. L. 86–70, § 12(d), June 25, 1959, 73 Stat. 143; Pub. L. 86–624, § 7(c), July 12, 1960, 74 Stat. 412; Pub. L. 91–547, § 2(a), Dec. 14, 1970, 84 Stat. 1413; Pub. L. 95–598, title III, § 310(a), Nov. 6, 1978, 92 Stat. 2676; Pub. L. 96–477, title I, § 101, Oct. 21, 1980, 94 Stat. 2275; Pub. L. 97–303, § 5, Oct. 13, 1982, 96 Stat. 1409; Pub. L. 100–181, title VI, §§ 601–603, Dec. 4, 1987, 101 Stat. 1260; Pub. L. 101–550, title II, § 206(a), Nov. 15, 1990, 104 Stat. 2720; Pub. L. 104–290, title I, § 106(c), title II, § 209(b), title V, §§ 503, 504, Oct. 11, 1996, 110 Stat. 3425, 3434, 3445; Pub. L. 105–353, title III, § 301(c)(1), Nov. 3, 1998, 112 Stat. 3236; Pub. L. 106–102, title II, §§ 213(a), (b), 215, 216, 223, Nov. 12, 1999, 113 Stat. 1397, 1399, 1401; Pub. L. 106–554, § 1(a)(5) [title II, § 209(a)(1), (3)], Dec. 21, 2000, 114 Stat. 2763, 2763A–435, 2763A–436; Pub. L. 109–291, § 4(b)(2)(A), Sept. 29, 2006, 120 Stat. 1337; Pub. L. 111–203, title VII, § 769, title IX, §§ 985(d)(1), 986(c)(1), July 21, 2010, 124 Stat. 1801, 1934, 1936.)

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Goodwin, Procter & Hoar
File No. 132-3

Your letter dated October 24, 1996 requests our concurrence with your views on three issues concerning the application of Section 7(d) of the Investment Company Act of 1940 ("Investment Company Act"). First, you request confirmation that investment companies formed under the laws of a jurisdiction other than the United States and not registered under the Investment Company Act ("Foreign Funds") may offer and sell their shares to U.S. residents that are "qualified purchasers" in accordance with the terms of new Section 3(c)(7) of the Act.[1] Second, you request our concurrence that Foreign Funds may rely on the definition of "U.S. person" in Rule 902(o) of Regulation S ("Reg. S") under the Securities Act of 1933 ("Securities Act") in considering whether a potential investor in a Foreign Fund is a U.S. resident beneficial owner for purposes of determining whether the Fund is acting in accordance with Section 7(d) of the Investment Company Act.[2] Third, you seek our concurrence that a Foreign Fund would not be deemed to violate the provisions of Section 7(d) if it sells its securities in an offering in the United States that is not a public offering within the meaning of Section 7(d) ("private offering") at the same time that it conducts an offshore public offering of its securities that complies with the provisions of Reg. S.

I. Background

Section 7(d) of the Investment Company Act prohibits a Foreign Fund from using the U.S. mails or any means or instrumentality of interstate commerce to offer or sell its securities in connection with a public offering unless the Commission issues an order permitting the Foreign Fund to register under the Investment Company Act. Section 7(d) authorizes the Commission to issue such an order only if the Commission finds that it is both legally and practically feasible to enforce the provisions of the Investment Company Act

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1 Section 3(c)(7) was added to the Investment Company Act by the National Securities Markets Improvement Act of 1996 (the "1996 Amendments").

2 Reg. S clarifies the extraterritorial application of the registration provisions under the Securities Act. Reg. S provides generally that Section 5 of the Securities Act does not apply to offers and sales of securities if both the offer and the sale occur outside the United States. Reg. S also includes two safe harbors for specified transactions: Rule 903 (the "issuer safe harbor") and Rule 904 (the "resale safe harbor"). Transactions that satisfy all the conditions of the applicable safe harbor are deemed to be made outside the United States and thus are not subject to the registration requirements of Section 5 of the Securities Act. See Securities Act Release No. 6863 (Apr. 24, 1990) (adopting Reg. S). Reg. S does not apply to offers and sales by open-end investment companies or unit investment trusts registered or required to be registered or closed-end investment companies required to be registered, but not registered, under the Investment Company Act. Preliminary note 8 to Reg. S.

against the Foreign Fund, and that the issuance of the order is consistent with the public interest and the protection of investors. Congress has indicated that Section 7(d) was intended to subject Foreign Funds that access the U.S. market to the same type and degree of regulation that applies to U.S. investment companies.[3]

By its terms, Section 7(d) does not address a private offering in the United States undertaken by a Foreign Fund. In light of the purpose of Section 7(d), however, the staff has interpreted and applied that section with reference to Section 3(c)(1) of the Investment Company Act. Section 3(c)(1) excepts from the definition of investment company any issuer whose securities are beneficially owned by not more than 100 persons and that is not making, and does not presently propose to make, a public offering of its securities (a "Section 3(c)(1) company").[4] In Touche Remnant & Co. (pub. avail. Aug. 27, 1984) ("Touche Remnant"), the staff concluded that a Foreign Fund could make a private offering in the United States without violating Section 7(d) only if after the private offering the Fund's securities are held by no more than 100 beneficial owners resident in the United States.[5]

The staff's position in Touche Remnant is intended to treat private offerings by Foreign Funds comparably to offerings undertaken by Section 3(c)(1) companies. Touche Remnant also reflects the staff's conclusion that, in drafting Section 7(d), Congress could not have intended Foreign Funds to be able to conduct private offerings in the United States to a greater extent than those permitted to be conducted by Section 3(c)(1) companies.[6]

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[3] See S. Rep. No. 1775, 76th Cong., 3d Sess. 13 (1940); H.R. Rep. No. 2639, 76th Cong., 3d Sess. 13 (1940).

[4] Section 3(c)(1) reflects a determination that public interest concerns arise when an investment company has more than 100 shareholders and that, as a result, the investment company should be required to register under the Investment Company Act. See Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess. 179 (1940).

[5] The Commission cited this position with approval in Securities Act Release No. 6862 (April 23, 1990) (adopting Rule 144A under the Securities Act).

[6] While Section 7(d), by its terms, prohibits only a "public offering" of securities by a Foreign Fund in the United States, applying the limits of Section 3(c)(1) to private offerings under Section 7(d) is consistent with Congress' intent in enacting Section 7(d). At the time Congress used the words "public offering" in Section 7(d), a non-public offering generally involved a very limited number of participants, well below the 100 investor limit of Section 3(c)(1). The traditional view, as expressed by the Commission's Office of General Counsel, was that although the determination of whether an offering was public was one of fact that should be made on a case-by-case basis, ordinarily an offering to more than 25 persons would be viewed as a public

The staff clarified the Touche Remnant position in a letter to the Investment Funds Institute of Canada (pub. avail. Mar. 4, 1996) ("IFIC"). In that letter, the staff recognized that, as a general matter, a Foreign Fund should not be deemed to have violated Section 7(d) if the 100 U.S. beneficial owner limit under Touche Remnant is exceeded due to the independent actions of the Fund's securityholders. Consistent with this principle, the Division stated that it would not recommend enforcement action under Section 7(d) if a Foreign Fund that has offered its securities privately to U.S. investors has more than 100 securityholders resident in the United States solely as a result of (1) the relocation of foreign securityholders of the Fund to the United States; or (2) offshore secondary market transactions not involving the Foreign Fund or its agents, affiliates or intermediaries.

II. Section 3(c)(7) and Section 7(d)

Section 3(c)(7) of the Investment Company Act provides a new exclusion from the definition of investment company for issuers whose securities are owned exclusively by "qualified purchasers," provided that the issuer is not making, and does not presently propose to make, a public offering of its securities ("Section 3(c)(7) companies," and together with Section 3(c)(1) companies, "private investment companies").[7] Section 3(c)(7) reflects the view that certain investors with a high degree of financial sophistication do not require the substantive protections of the Investment Company Act.[8]

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offering. Securities Act Release No. 285 (Jan. 24, 1935). Twenty-five persons remained the generally accepted ceiling for private offers for a number of years. See L. Loss and J. Seligman, The Fundamentals of Securities Regulation, 308 (1995).

The concept of a "public offering" has evolved considerably since 1940. E.g., Rules 505 and 506 of Regulation D under the Securities Act (permitting private offerings involving an unlimited number of accredited investors). We believe, however, that Section 7(d) should be interpreted in a manner consistent with both Congressional intent and the policies and purposes of the Investment Company Act as a whole. We believe it inconsistent with Congressional intent and the regulatory framework established by the Investment Company Act for a Foreign Fund to be able to offer its securities privately to more U.S. residents than could a Section 3(c)(1) company.

7 The term "qualified purchaser" is defined in new Section 2(a)(51) to include (1) individuals and certain family companies that have not less than $5 million in "investments," (2) certain trusts if both the trustee or other person with investment discretion and all settlors or other contributors are qualified purchasers, and (3) other persons that own and invest on a discretionary basis not less than $25 million in "investments." The Commission has proposed rules that would define "investments" for purposes of Section 2(a)(51). Investment Company Act Release No. 22405, (December 18, 1996).

8 See H.R. Rep. No. 622, 104th Cong., 2d Sess. 18 (1996).

As noted above, Section 7(d) reflects a Congressional determination that Foreign Funds that access the U.S. market should be subject to the same type and degree of regulation that applies to U.S. investment companies. Consistent with this principle, we believe that a Foreign Fund may privately offer and sell its securities to qualified purchasers in the United States in accordance with the provisions of Section 3(c)(7) (and any Commission rules promulgated under the section) without violating Section 7(d).[9] A Foreign Fund that wishes to offer its securities privately in the United States, like a U.S. private investment company, may rely on either Section 3(c)(1) or Section 3(c)(7).[10] In addition, a Foreign Fund that has sold its securities to 100 or fewer U.S. resident beneficial owners in the manner outlined in Touche Remnant may, like a U.S. private investment company, rely on the "grandfathering" provision of Section 3(c)(7)(B) to privately offer securities to qualified purchasers in accordance with Section 3(c)(7).[11] We also believe that it is consistent with the purpose of Section 7(d) for a Foreign Fund relying on Section 3(c)(1) or Section 3(c)(7) to comply with the "consent" provision in Section 2(a)(51)(B) of the Investment Company Act to the extent that it intends to be deemed a qualified purchaser of securities of Section 3(c)(7) companies.[12]

III. Section 7(d) and "U.S. Person"

A Foreign Fund seeking to make a private offering in the United States must determine whether existing or prospective shareholders should be considered beneficial

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[9] In our view, the non-U.S. resident shareholders of a Foreign Fund relying on Section 3(c)(7) to offer its securities in the United States need not be qualified purchasers.

[10] As is the case with domestic private investment companies, a Foreign Fund may not simultaneously seek to rely on Section 3(c)(7) to offer securities to U.S. resident qualified purchasers <u>and</u> Section 3(c)(1) to offer securities to 100 U.S. residents who are not qualified purchasers.

[11] Section 3(c)(7)(B) allows certain existing Section 3(c)(1) companies to convert to Section 3(c)(7) companies and "grandfather" their existing investors that are not qualified purchasers, provided that those investors receive appropriate disclosure and adequate notice and opportunity to redeem their investments. In applying the grandfathering provision, a Foreign Fund must meet the requirements of that provision only with respect to those U.S. resident beneficial owners that should be counted under the principles set out in IFIC.

[12] Section 2(a)(51)(B) requires a private investment company that wishes to become a qualified purchaser to obtain the consent of all its beneficial owners that invested in it prior to April 30, 1996. We believe that a Foreign Fund need comply with this provision only with respect to U.S. resident beneficial owners that are to be counted under the principles set out in IFIC.

owners resident in the United States for purposes of Section 7(d).[13] You suggest that it would be appropriate and consistent with previous staff positions[14] for a Foreign Fund making a private offering in the United States within the meaning of Section 7(d) to rely on the definition of "U.S. person" in Rule 902(o) of Reg. S for purposes of determining whether an investor should be deemed a U.S. resident beneficial owner.

We believe that the definition of U.S. person in Rule 902(o) of Reg. S can be used generally in the context of Section 7(d) of the Investment Company Act. Reliance on certain provisions of Rule 902(o), however, may under certain circumstances raise issues under Section 48(a) of the Investment Company Act.[15] Our views with respect to the relevant provisions of Rule 902(o) are set forth below.

a. *Natural Persons*

A natural person's residency, rather than citizenship, determines his or her status under Rule 902(o)(1)(i) of Reg. S. For example, a citizen of another country residing in the United States is a U.S. person under Reg. S, while a U.S. citizen residing abroad is not a U.S. person. We believe that residency should also determine whether an individual must be considered a U.S. resident beneficial owner for purposes of Section 7(d). Thus, we conclude that it would be appropriate for a Foreign Fund to count as U.S. resident beneficial owners those natural persons who would be considered to be U.S. persons under Rule 902(o)(1)(i).

In our view, a distinction should be made under Section 7(d), as under Reg. S, between persons permanently residing abroad, and U.S. residents who are temporarily abroad. U.S. citizens and other persons permanently residing abroad who purchase securities

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13 Your letter does not contemplate the situation in which a Foreign Fund does not use U.S. jurisdictional means in connection with the offer or sale of any of its securities. The staff has taken the view that such a Foreign Fund is not subject to Section 7(d), even if U.S. residents purchase the Fund's securities in transactions that occur outside the United States. See Global Mutual Fund Survey (pub. avail. July 14, 1992).

14 See, e.g., Merrill, Lynch & Co., Inc. (pub. avail. May 12, 1986) ("Merrill"); Prudential-Bache Securities, Inc. (pub. avail. Aug. 17, 1987) ("Prudential"); G.T. Global Financial Services, Inc. (pub. avail. Aug. 2, 1988) ("G.T. Global"). In each of these letters, the requesting party defined the term "U.S. resident" to include: (1) a citizen or resident of the United States; (2) a partnership organized or existing in any state, territory or possession of the United States; (3) a corporation organized under the laws of the United States; and (4) any estate or trust, other than an estate or trust the income of which from sources without the United States is not includible in gross income for purposes of computing United States income tax payable on it.

15 Section 48(a) of the Investment Company Act prohibits any person from doing indirectly what he or she would be prohibited from doing directly under that Act.

may be deemed to have chosen foreign markets, and the laws and regulations applicable to those markets.[16] U.S. residents who are temporarily abroad, however, should be treated differently because they continue to maintain a permanent presence in the United States that warrants full protection under the federal securities laws. Thus, a Foreign Fund that has made or proposes to make a private offering in the United States and that has sold its securities to a U.S. resident who is temporarily outside the United States should treat that person as a beneficial owner resident in the United States for purposes of Section 7(d).[17]

b. *Partnerships and Corporations*

(i) *General Rule*

Rule 902(o)(1)(ii) of Reg. S includes within the definition of U.S. person "any partnership or corporation organized or incorporated under the laws of the United States." Rule 902(o)(1)(v) of Reg. S includes within the definition of U.S. person "any agency or branch of a foreign entity located in the United States." We believe that entities that are deemed U.S. persons under these subsections should likewise be treated as U.S. resident beneficial owners for purposes of Section 7(d).[18]

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16 See Securities Act Release No. 6863, supra note 2.

17 Whether a person is temporarily or permanently residing outside the United States is a factual question that depends on all of the circumstances surrounding that person's presence in a foreign country. See Securities Exchange Act Release No. 27017 (July 11, 1989) (adopting Rule 15a-6 under the Securities Exchange Act of 1934).

18 This conclusion is consistent with earlier positions taken by the staff. See, e.g., Merrill, Prudential, and G.T. Global, supra note 14. Each letter defined the term "U.S. resident" to include a partnership organized or existing in any state, territory or possession of the United States, and a corporation organized under the laws of the United States.

We note that in determining the number of beneficial owners for purposes of Section 3(c)(1), a "company" (e.g., a partnership or corporation) that invests in a Section 3(c)(1) company generally is presumed to be a single beneficial owner. Under the 1996 Amendments, however, if the acquiring company (1) owns more than 10% of the stock of the Section 3(c)(1) company and (2) is (or but for Section 3(c)(1) or Section 3(c)(7) would be) an investment company itself, the Section 3(c)(1) company is required to count the beneficial owners of the acquiring company towards the 100 beneficial owner limit. The staff has taken the position under Section 48(a) of the Investment Company Act that if a "company" that invests in a private investment company is simply a device for facilitating individual investment decisions of its securityholders, then the company's securityholders should be deemed to be the beneficial owners of the company's investment in the private investment company.

(ii) *Offshore Investment Vehicles for U.S. Persons*

Rule 902(o)(1)(viii) provides that the term U.S. person includes any partnership or corporation organized under foreign law by a U.S. person "principally for the purpose of investing" in unregistered securities, unless the partnership or corporation is organized and owned by accredited investors (as that term is defined in Regulation D under the Securities Act) that are not natural persons, estates or trusts.[19] Subsection (1)(viii) is intended to prevent the circumvention of the registration provisions of the Securities Act through the use of an offshore entity formed for the purpose of purchasing securities in Reg. S offerings, unless the entity is formed by sophisticated non-natural persons that can invest directly in unregistered securities without the protections of the Securities Act.[20]

We believe that offshore entities that are deemed U.S. persons under Subsection (1)(viii) should be treated as U.S. resident beneficial owners for purposes of Section 7(d). We also believe that the offshore entities formed by U.S. accredited investors that are excluded from the definition of U.S. person by Subsection (1)(viii) generally need not be treated as U.S. resident beneficial owners for purposes of Section 7(d). To the extent, however, that a Foreign Fund facilitates the use of an offshore entity by U.S. accredited investors as a means to evade the requirements of Section 7(d), we believe that the Foreign Fund would violate Section 48(a).[21]

See WR Investment Partners (pub. avail. Apr. 15, 1992) (limited partners deemed the beneficial owners of the partnership's interest in a Section 3(c)(1) company). In our view, these principles should similarly apply in the context of a private U.S. offering by a Foreign Fund relying on Touche Remnant.

19 Rule 501(a) of Regulation D defines the term "accredited investor" to include, among others, a bank as defined in Section 3(a)(2) of the Securities Act, a savings and loan association as defined in Section 3(a)(5)(A) of the Securities Act, a broker or dealer registered under Section 15 of the Securities Exchange Act of 1934, any business development company as defined in Section 2(a)(48) of the Investment Company Act, an investment company registered under the Investment Company Act, and certain employee benefit plans.

20 See Securities Act Release No. 6863, supra note 2.

21 See supra note 15. We note that if a Foreign Fund deems an offshore entity covered by Rule 902(o)(1)(viii) to be a U.S. resident beneficial owner for purposes of Section 7(d), to the extent that the entity meets the definition of qualified purchaser under Section 2(a)(51) of the Investment Company Act, it may be treated as a qualified purchaser by a Fund seeking to comply with the requirements of Section 3(c)(7). As in the domestic context, however, the offshore entity may not be used as a vehicle for evading the qualified purchaser requirement of Section 3(c)(7). The sponsor of the

(iii) *Foreign Agencies or Branches*

Rule 902(o)(6) excludes from the definition of U.S. person any agency or branch of a U.S. bank or insurance company located outside the United States if it: (1) operates for valid business reasons; (2) is engaged in the banking or insurance business; and (3) is subject to substantive banking or insurance regulation in the jurisdiction in which it is located. We see no policy reason for treating these entities differently under Section 7(d). Therefore, for purposes of Section 7(d), a Foreign Fund need not count as U.S. resident beneficial owners any entity described in Rule 902(o)(6).[22]

c. *Trusts, Estates, Discretionary and Non-Discretionary Accounts*

(i) *General Rule*

Under Rule 902(o)(1)(iv) and (o)(1)(iii) of Reg. S, respectively, a trust or estate is a U.S. person if any trustee, executor or administrator is a U.S. person. We believe that it is consistent with the purpose of Section 7(d) for a Foreign Fund to look to this provision of Reg. S in determining whether a trust or estate should be deemed a beneficial owner resident in the United States for purposes of Section 7(d).[23]

Rule 902(o)(1)(vi) includes within the definition of U.S. person any non-discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary for the benefit of a U.S. person. Rule 902(o)(vii) includes within the definition of U.S. person any discretionary account (other than an estate or trust) that is held by a dealer or other fiduciary organized, incorporated or resident in the United States. These provisions are based on the principle that the person or entity that has the power to direct the investment of an account's assets should be deemed to be the buyer for purposes of determining the locus

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Foreign Fund could not, for example, establish the offshore company solely for the purpose of creating a qualified purchaser when the U.S. resident owners of the offshore company could not meet the qualified purchaser requirement individually. See H.R. Rep. 622, supra note 8 at 52 ("a promoter of a Section 3(c)(7) fund could not organize a 'sham' Section 3(c)(1) fund to facilitate investment by non-qualified purchasers in the Section 3(c)(7) fund").

22 Any branch or agency of a foreign entity that is located in the United States would, however, be a U.S. resident beneficial owner.

23 This treatment of trusts and estates differs from that reflected in earlier staff letters relating to Section 7(d). See Merrill and G.T. Global, supra note 14 (requesters relied on the "sourcing of income" rules under the Internal Revenue Code in determining whether a foreign trust or estate was a "beneficial owner resident in the United States"). In issuing this letter, the staff is not rescinding those previous letters, which may continue to be relied upon.

of an offering.[24] The effect of these provisions is that an account managed by a U.S. person will be deemed a U.S. person. We believe that the treatment of accounts under these provisions is consistent with the requirements of Section 7(d), and the accounts covered by these provisions should be treated as U.S. resident beneficial owners for purposes of Section 7(d).[25]

(ii) *Exceptions*

Rule 902(o)(2) provides an exception from the definition of U.S. person for discretionary accounts held for the benefit of a non-U.S. person by a dealer or other professional fiduciary organized, incorporated, or resident in the United States. Rule 902(o)(4) provides a similar exception for a trust having a U.S. person acting as a trustee if (1) a trustee who is not a U.S. person has sole or shared investment discretion and (2) no beneficiary of the trust (or settlor if the trust is revocable) is a U.S. person. Likewise, Rule 902(o)(3) provides that an estate having a U.S. professional fiduciary acting as administrator or executor is not a U.S. person if: (1) an administrator or executor of the estate who is not a U.S. person has sole or shared investment discretion with respect to the assets of the estate; and (2) foreign law governs the estate. In adopting Reg. S, the Commission noted the serious competitive disadvantages that U.S. professional fiduciaries, particularly smaller U.S. advisers, might face if these exceptions were not made.[26]

We believe the treatment of accounts, trusts, or estates held for the benefit of non-U.S. persons in Subsections (o)(2), (o)(4) or (o)(3) of Rule 902 is consistent with the purpose of Section 7(d). Moreover, the staff has acknowledged that the same type of competitive harm to U.S. trustees and professional fiduciaries that could result if these trusts, estates and accounts are considered beneficial owners resident in the U.S. for purposes of Section

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[24] See Securities Act Release No. 6779 (Jun. 10, 1988) (proposing Reg. S).

[25] The release adopting Reg. S also stated that when a foreign fiduciary or other entity has full investment discretion for the account of a U.S. person, that account is not treated as a U.S. person. Securities Act Release No. 6863, supra note 2. Because such an account is managed by a non-U.S. person, we generally agree with this treatment for purposes of determining who is a U.S. resident under Section 7(d). To the extent, however, that a Foreign Fund facilitates the use of foreign discretionary accounts by U.S. persons as a means to evade the requirements of Section 7(d), we believe that the Foreign Fund would violate Section 48(a). See supra note 15.

[26] See Securities Act Release No. 6863, supra note 2.

7(d).[27] We believe, therefore, that Foreign Funds need not treat the entities covered by these subsections as U.S. resident beneficial owners under Section 7(d).

d. *Employee Benefit Plans*

Under Rule 902(o)(5) of Reg. S, an employee benefit plan established and administered in accordance with the law of a country other than the United States is not deemed to be a U.S. person. We believe that an employee benefit plan that is established and administered under the law of a country other than the United States ordinarily should also not be deemed a U.S. resident beneficial owner under Section 7(d).[28]

e. *International Organizations Operating in the United States*

Rule 902(o)(7) excludes certain international organizations, their agencies, affiliates, and pension plans from the definition of U.S. person. We believe that the entities covered by Rule 902(o)(7) also need not be considered U.S. resident beneficial owners for purposes of Section 7(d).

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27 See Fiduciary Trust Global Fund (pub. avail. Aug. 2, 1995) (excluding discretionary accounts held for the benefit of non-U.S. persons by brokers and other professional fiduciaries organized in the United States (as defined in Rule 902(o)(2) of Reg. S) from the 100 purchaser limit under Touche Remnant).

28 These employee benefit plans may be treated as non-U.S. residents notwithstanding that there may be some U.S. residents who are participants. This represents a modification of the position taken in Scimitar Global Pension Fund (pub. avail. Aug. 9, 1990) and Win Global Fund (pub. avail. May 14, 1991), in which the staff granted no-action assurance to funds offering shares to pension plans of foreign subsidiaries of large U.S. multi-national corporations, if both the plans' administrators and any participating employees who were U.S. citizens were located outside the United States.

We note that Section 4(b)(4) of the Employee Retirement Income Security Act of 1974 ("ERISA") provides a similar exception for employee benefit plans "maintained outside the United States primarily for the benefit of persons substantially all of whom are nonresident aliens...." A foreign employee benefit plan that has significant participation by U.S. citizens or residents, however, likely will be subject to ERISA. See, e.g., Department of Labor - Pension and Welfare Benefits Administration - Advisory Opinions 80-5 (Jan. 28, 1980) (exemption not available when 1,900 participants (of a total of 25,277) were U.S. citizens); 78-26 (Nov. 27, 1978) (exemption not available when 60 participants (out of a total 110) were U.S. citizens).

IV. Integration of U.S. Private Offerings and Reg. S Offerings by Foreign Funds.

You maintain that a Foreign Fund should not be deemed to violate the provisions of Section 7(d) if it sells its securities in a private offering in the United States at the same time that it conducts an offshore public offering that complies with the provisions of Rule 903 of Reg. S. You note that offers and sales by a foreign issuer[29] (including a Foreign Fund) that does not have a "substantial U.S. market interest"[30] need only satisfy two conditions to comply with the Rule 903 safe harbor: (1) the offer and sale must be made in an "offshore transaction"[31] and (2) there may be no "directed selling efforts"[32] in the United States. These conditions focus on the location of the offering activity and the location of the prospective purchaser, but do not require an examination of the purchaser's residence. Such foreign issuers are not precluded by Reg. S from selling to U.S. persons in the offering,

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29 A foreign issuer is defined under Rule 902(f) to include, among other things, "a corporation or other organization incorporated or organized under the laws of any foreign country" unless the issuer has (1) more than 50% of its voting securities held by record holders with a U.S. address and (2) either (A) the majority of the executive officers or directors of the issuer are U.S. citizens or residents, (B) more than 50% of the assets of the issuer are located in the United States, or (C) the business of the issuer is administered principally in the United States.

30 Substantial U.S. market interest for an equity security is defined under Rule 902(n) to exist when (1) U.S. securities exchanges or inter-dealer quotation systems constitute the largest market for the security, or (2) 20% or more of all trading of the security takes place on or through the facilities of securities exchanges or inter-dealer quotation systems in the United States and less than 55% of all trading of the security takes place in any one single country.

31 Under Rule 902(i), an offer or sale is made in an "offshore transaction" if (1) the offer is not made to a person in the United States, and (ii) either (A) at the time the buy order is originated, the buyer is outside the United States (or the seller reasonably believes the buyer is outside the United States) or (B) the sale is through the physical trading floor of an established foreign securities exchange.

32 "Directed selling efforts" are defined in Rule 902(b) as activities undertaken for the purpose of, or that could reasonably be expected to result in, conditioning of the market in the United States for securities being offered (e.g., marketing efforts in the United States designed to induce the purchase of the securities purportedly being distributed abroad). Activities such as mailing printed material to U.S. investors, conducting promotional seminars in the United States, or placing advertisements with radio or television stations broadcasting into the United States or in publications with a general circulation in the United States, which discuss the offering or could reasonably be expected to condition the market for the securities being offered abroad, would constitute directed selling efforts in the U.S.

provided that the two conditions are met. Rule 903, therefore, would permit a Foreign Fund with no substantial U.S. market interest, but that has made or proposes to make a private U.S. offering, to make an offshore sale to a U.S. resident, without violating the registration provisions of the Securities Act.

In Touche Remnant, the staff took the position that, generally, a Foreign Fund's private U.S. offering would be viewed as separate from the Fund's simultaneous offshore public offering. The staff took the position, therefore, that Section 7(d) does not prohibit a Foreign Fund from conducting a private U.S. offering simultaneously with an offshore public offering, provided that the Foreign Fund does not use U.S. jurisdictional means in connection with the offshore offering.[33] We believe that the same principle should apply in the case of a Foreign Fund seeking to make a private offering in the United States under Section 3(c)(7) at the same time that it is making a public offering outside the United States. We believe, therefore, that Section 7(d) does not prohibit a Foreign Fund from conducting a private U.S. offering in compliance with Section 3(c)(7) simultaneously with an offshore public offering.

We note that, in our view, compliance of a Foreign Fund's offshore offering with the terms of Rule 903 does not necessarily mean that the offshore offering does not raise issues with respect to the Fund's private U.S. offering. As noted above, Rule 903 would permit a Foreign Fund to make a sale to a U.S. person in an offshore transaction without requiring the registration of the offering. Under the staff's interpretation of Section 7(d) in Touche Remnant and IFIC, a Foreign Fund must generally count as U.S. resident beneficial owners all U.S. residents who have purchased directly or indirectly from the Foreign Fund, its agents, affiliates, or intermediaries.[34] The staff also indicated in IFIC that when a Foreign Fund, its agents, affiliates, or intermediaries had sold shares to a U.S. resident beneficial owner in a transaction occurring outside the United States, it was appropriate to count that U.S. resident towards the 100 person limit. The requirement of counting sales to U.S. residents occurring outside the United States is intended to assure that the prohibitions of

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[33] See also KBS International Ltd. (pub. avail. Mar. 18, 1985). The staff has recognized an offshore offering that involves only incidental U.S. jurisdictional contacts does not violate Section 7(d). See G.T. Global, supra note 14 (limited use of U.S. mails for the sale of foreign investment company securities to non-resident aliens through U.S. broker-dealers permitted under Section 7(d)).

[34] As noted above, the staff stated in IFIC that a Foreign Fund need not count toward the 100 purchaser limit U.S. resident beneficial owners who purchased shares (1) directly from the Fund while residing abroad, or (2) in secondary market transactions not involving the fund or its agents, affiliates, or intermediaries.

Section 7(d) are not circumvented by purposefully structuring offers and sales of shares of Foreign Funds to U.S. persons as offshore transactions.[35]

In our view, therefore, it would be inconsistent with the requirements of Section 7(d) of the Investment Company Act to rely on Rule 903 to determine whether a Foreign Fund has complied with the limits on private offerings required by Section 7(d). Rather, to the extent that a Foreign Fund has sold securities to a U.S. person in an offshore transaction in reliance on Rule 903, that U.S. person would be deemed a U.S. resident beneficial owner for purposes of Section 7(d) and a Foreign Fund that makes a private offering in the United States in reliance on Touche Remnant would have to count that U.S. person toward the 100 investor limit of Section 3(c)(1). Similarly, a Foreign Fund that was making a private placement in the United States in reliance on Section 3(c)(7) would have to determine whether the U.S. person was a qualified purchaser.

Phillip S. Gillespie
Senior Counsel

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35 As noted above, supra note 13, a Foreign Fund that has never used U.S. jurisdictional means in connection with the offer or sale of any of its securities is not subject to Section 7(d), even if U.S. residents purchase the Fund's securities in transactions that occur outside the United States. If that Foreign Fund subsequently seeks to offer its securities in the United States, however, it must count those U.S. residents to whom it previously sold securities towards the U.S. beneficial owner limits imposed by Section 7(d).

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Investment Company Act of 1940--Section 7(d)

October 24, 1996

Office of Chief Counsel
Division of Investment Management
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549

Attention: John V. O'Hanlon, Assistant Chief Counsel

Ladies and Gentlemen:

We are seeking your interpretative advice on an issue of importance to investment companies organized outside of the United States ("offshore funds"), including many of our clients: the effect of the National Securities Markets Improvement Act of 1996 (the "1996 Improvement Act") upon the Touche Remnant doctrine under Section 7(d) of the Investment Company Act of 1940, as amended (the "1940 Act"). We are also asking that you clarify the interrelationship between the Touche Remnant doctrine and Regulation S under the Securities Act of 1933, as amended (the "1933 Act").

Specifically, we ask you to confirm that, upon the effectiveness of Section 3(c)(7) of the 1940 Act,[1] offshore funds may offer and sell their shares to U.S. residents in accordance with the limitations imposed by either Section 3(c)(1) or Section 3(c)(7). Secondly, we ask you to confirm that the definition of a U.S. person set forth in Rule 902(o) of Regulation S may be used for purposes of determining who is a resident in the United States under the Touche Remnant doctrine.[2] Finally, we ask you to confirm that a public offering outside of

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1 Pursuant to the 1996 Improvement Act, Section 3(c)(7) will take effect on the earlier of 180 days after its enactment or the date upon which rulemaking is completed to define the term "investments," which is a component of the term "qualified purchaser."

2 The Staff has recently indicated that a U.S. investor who acquires shares in a secondary market transaction without the direct or indirect involvement of the offshore fund, its affiliates, agents or intermediaries and in compliance with certain other conditions will not be regarded as a U.S. resident for purposes of the Touche Remnant doctrine. See note 13 to Investment Funds Institute of Canada (March 4, 1996). Accordingly, we

the United States by an offshore fund relying upon the Touche Remnant doctrine will not be integrated with a private placement inside the United States so long as the offshore offering is conducted in compliance with Regulation S.

I. THE TOUCHE REMNANT DOCTRINE.

In a series of no-action letters beginning with Touche, Remnant & Co. (August 27, 1984), the Staff has stated that it would not recommend that the Commission take any enforcement action against offshore funds for failing to register under the 1940 Act, provided that they do not publicly offer their securities in the United States and that they limit ownership of their securities to no more than 100 beneficial owners resident in the U.S. This position is sometimes referred to as the "Touche Remnant doctrine." While the Touche Remnant doctrine originated as a Staff no-action position, in 1990 it was endorsed by the Commission in its release adopting Rule 144A under the 1933 Act.[3]

The Touche Remnant doctrine involves an interpretation of Section 7(d) of the 1940 Act. Section 7(d) provides in relevant part that "[n]o investment company, unless organized or otherwise created under the laws of the United States or of a State . . . shall make use of the mails or any means or instrumentality of interstate commerce, directly or indirectly, to offer for sale, sell, or deliver after sale, in connection with a public offering, any security of which such company is the issuer." Thus, on its face Section 7(d) only prohibits an offshore fund from making a U.S. public offering; the statute contains no express limitation on the number of U.S. resident beneficial owners of an offshore fund. In *Touche Remnant,* the Staff rejected a literal reading of Section 7(d). Instead, the Staff essentially adopted a bifurcated approach to the regulation of offshore funds: as to any offering to U.S. residents, an offshore fund would be subject to the same restrictions as a domestic private investment company; however, the 1940 Act would not be deemed to restrict the scope of any offering to non-U.S. residents.

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understand that, regardless of whether the Staff accepts the Regulation S definition, such secondary market investors would not constitute U.S. residents for purposes of the Touche Remnant doctrine.

[3] See Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities under Rules 144 and 145, Securities Act Release 6862 (April 23, 1990), Fed. Sec. L. Rep. (CCH) ¶84,523 at p. 80,648. The Commission's formulation of the Touche Remnant doctrine referred to "100 beneficial owners who are U.S. residents."

II. APPLYING TOUCHE REMNANT UNDER 3(c)(7).

To date, domestic private investment companies have been required to comply with the provisions of Section 3(c)(1) under the 1940 Act ("3(c)(1) funds"). As noted above, the 1996 Improvement Act contemplates a new type of private investment company under Section 3(c)(7) of the 1940 Act (a "3(c)(7) fund"). A 3(c)(7) fund will be able to have an unlimited number of security holders, provided that it does not make a public offering and that its outstanding securities are owned exclusively by persons who, at the time of acquisition, are "qualified purchasers," as defined in the new Section 2(a)(51) of the 1940 Act. Upon effectiveness of this portion of the 1996 Improvement Act, the 1940 Act will recognize two types of domestic private investment companies, 3(c)(1) funds and 3(c)(7) funds.[4]

As noted above, the premises of the Touche Remnant doctrine are that in conducting any offering to U.S. residents, an offshore fund should be subject to the same rules as a domestic private investment company, but that the 1940 Act should not be deemed to restrict the scope of any offering to non-U.S. residents. We respectfully submit that these premises support an extension of the Touche Remnant doctrine. Accordingly, we ask you to confirm that offshore funds will be permitted to offer and sell its shares without limitation to non-U.S. residents, provided that, as to U.S. residents, they conduct their activities in accordance with the limitations applicable to either 3(c)(1) funds or 3(c)(7) funds.

III. THE RELATIONSHIP BETWEEN TOUCHE REMNANT AND REGULATION S.

A. Regulation S. In 1990 the Commission adopted Regulation S to clarify the extraterritorial application of the registration provisions of the 1933 Act.[5] Regulation S provides generally that any offer or sale that occurs within the United States is subject to Section 5 of the 1933 Act and any offer or sale that occurs outside the United States is not

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[4] The 1996 Improvement Act contemplates that Section 3(c)(1) will remain in effect, with some modification to the "look through" provisions used for computing the number of beneficial owners of a fund's outstanding voting securities and the provisions affecting the relationship between Section 3(c)(1) and Section 12(d)(1). Certain transition rules apply which enable existing 3(c)(1) funds to become 3(c)(7) funds.

[5] See Offshore Offers and Sales, Securities Act Release 6863; Exchange Act Release 27942; Investment Company Act Release No. 17458 (April 24, 1990) Fed. Sec. L. Rep. (CCH) ¶84,524 at p. 80,661 (hereinafter, the "Adopting Release"). Regulation S was initially proposed in Securities Act Release No. 6779 (June 10, 1988), Fed. Sec. L. Rep. (CCH) ¶84,426 at p. 80,209 (hereinafter the "Proposing Release"). It was re-proposed in Offshore Offers and Sales, Securities Act Release No. 6838 (July 11, 1989), Fed. Sec. L. Rep. (CCH) ¶84,426, at p. 80,209 (hereinafter the "Re-Proposing Release").

subject to Section 5. Additionally, Regulation S provides two "safe harbors" for specified transactions. Offers and sales meeting all of the conditions of the applicable safe harbor are deemed to be outside the United States and, therefore, not subject to Section 5 of the 1933 Act.

The underlying principles of these safe harbors and of Regulation S generally are comity[6] and a territorial approach to the application of Section 5 of the Securities Act.[7] This approach focuses on protection of U.S. capital markets and protection of all investors acquiring securities in such markets, without regard to the citizenship of such investors. The Commission stated:

> Principles of comity and reasonable expectations of participants in the global markets justify reliance on laws applicable in jurisdictions outside the United States to define disclosure requirements for transactions effected offshore. The territorial approach recognizes the primacy of the laws in which a market is located. As investors choose their markets, they would choose the disclosure requirements applicable to such markets.[8]

Consistent with this approach, certain transactions (including offers and sales by foreign private issuers whose securities have no substantial U.S. market interest)[9] need satisfy

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[6] "The doctrine of comity emphasizes restraint and tolerance to other nations in international affairs. . . . Among the values stressed by the doctrine of comity is 'the limited application of sovereign powers to extraterritorial events and persons.'" Proposing Release, note 61 at p. 89,128 (citations omitted).

[7] Id.; see also Adopting Release at p. 80,662.

[8] Proposing Release at p. 89,128. See also Adopting Release at p.80,665.

[9] "Substantial U.S. market interest" is defined under Rule 902(n) of Regulation S to exist, with respect to a class of an issuer's equity securities when "(i) [t]he securities exchanges and inter-dealer quotation systems in the United States in the aggregate constituted the single largest market for such class of securities in the shorter of the issuer's prior fiscal year or the period since the issuer's incorporation; or (ii) 20 percent or more of all trading in such class of securities took place in, on or through the facilities of securities exchanges and inter-dealer quotation systems in the United States and less than 55 percent of such trading took place in, on other through the facilities of securities markets of a single foreign country in the shorter of the issuer's prior fiscal year or the period since the issuer's incorporation." The term "foreign issuer" is defined in Rule 902(f) of Regulation S to include a corporation or other organization incorporated or organized under the laws of any foreign country. In light of these definitions, it is virtually certain that any offshore fund would be a foreign issuer whose securities have no substantial U.S. market

only two conditions to comply with the safe harbor: that (a) the offer or sale be made in an "offshore transaction"[10] and (b) there be no "directed selling efforts"[11] in the United States.[12] These conditions focus on the location of the activity and of the prospective purchaser, but generally do not require an examination of the purchaser's nationality or permanent residence. Such issuers are not specifically precluded from offering securities to U.S. persons or obligated to bar resales to U.S. persons for any particular period of time.[13]

Certain other transactions (including offers and sales by U.S. issuers which file reports pursuant to the Securities Exchange Act of 1934) must satisfy additional requirements designed to restrict the "flow back" of unregistered securities into the hands of persons whom the United States has a strong regulatory interest in protecting.[14] The definition of U.S. person in Rule 902(o) of Regulation S is used primarily for purposes of these "flow back" restrictions.

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interest for purposes of Regulation S.

[10] An "offshore transaction" is defined under Rule 902(i) of Regulation S. An offer or sale is made in an offshore transaction when, for example, the offer is not made to a person in the United States and at the time the buy order is originated, the buyer is outside the United States.

[11] "Directed selling efforts" are defined as "any activity undertaken for the purpose of, or that could reasonably be expected to have the effect of, conditioning the market in the United States for any of the securities being offered in reliance on this Regulation S. Such activity includes placement of an advertisement in a publication with a general circulation in the United States that refers to the offering of securities being made in reliance upon this Regulation S." Regulation S, Rule 902(b). In the *Investment Funds Institute of Canada* letter, the Staff stated that it would generally look to the definition of "directed selling efforts" under Regulation S for purposes of determining when an offshore fund was conditioning the U.S. market. Legitimate U.S. selling activities in connection with the sale of securities in a private placement exempt under Section 4(2) or Rule 506 generally will not result in directed selling efforts. See Adopting Release, note 64 at p. 80,670.

[12] See Regulation S, Rule 903.

[13] Of course, Regulation S incorporates the general principle that the safe harbors are not available with respect to any transaction or series of transactions that, although in technical compliance with the relevant rules, "is part of a plan or scheme to evade the registration provisions of the [1933] Act." Preliminary Note 2 to Regulation S.

[14] On June 27, 1995, the Commission published a release stating its views with respect to certain problematic practices in connection with offers and sales under Regulation S. Securities Act Release No. 7130. On October 10, 1996 the Commission adopted revisions to certain forms designed in part to address abusive practices in connection with the sale of equity securities by domestic companies in purported Regulation S offerings. Securities Exchange Act Release No. 37801. We do not believe that either of these developments has any bearing on the interpretative advice sought by this letter.

The Commission clearly intended that Regulation S would be available to registered closed-end investment companies and investment companies that are not required to register under the 1940 Act.[15] Although, Regulation S, by its terms, only provides relief under the 1933 Act, the Staff has traditionally looked to 1933 Act concepts in determining whether any offering to U.S. investors is a bona fide private placement for purposes of the Touche Remnant doctrine.[16]

B. The Definition of a "U.S. Resident" under Touche Remnant. As noted above, the Staff in *Touche Remnant* referred to "100 beneficial owners resident in the U.S." The Commission's formulation of the doctrine referred to "100 beneficial owners who are U.S. residents." Neither of these formulations provides guidance as to the status of investors that are not natural persons. At present, offshore funds seeking to comply with the

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15 See Adopting Release at p. 80,664. Preliminary Note 8 to Regulation S provides, "[t]he provisions of this Regulation S shall not apply to offers and sales of securities issued by open-end investment companies or unit investment trusts registered or required to be registered or closed-end investment companies required to be registered, but not registered, under the Investment Company Act of 1940."

16 Neither the Adopting Release nor Regulation S itself addresses the Regulation's interrelationship with the Touche Remnant doctrine and existing no-action letters do not provide clear guidance.

In Alpha Finance Corporation Limited (July 27, 1990), the Staff granted no-action relief where the issuer contemplated offering a class of "U.S. Notes" and a class of "Euro-notes." U.S. Notes could not be held by more than 100 beneficial owners. Euro-notes were not subject to any such numerical limitation, but would be sold in compliance with Regulation S and could not be held by any U.S. person (as defined in Rule 902(o) of Regulation S). However, in Win Global Fund (May 14, 1991), *Alpha Finance* was cited for the proposition that the Staff has not expressed an opinion regarding the status of a foreign investment company under Section 7(d) making an offshore offering in reliance upon Regulation S, thus raising a question about the meaning of *Alpha Finance*.

MEC Finance USA, Inc. (Oct. 25, 1991), although not involving the Touche Remnant doctrine, is of some relevance. *MEC Finance* involved a proposal by a Delaware subsidiary of a Japanese corporation to sell medium term notes in Europe in accordance with Rule 903 under Regulation S without registering as an investment company under the 1940 Act in reliance upon Rule 3a-5 thereunder. The Staff stated, [B]ecause the Euro-Notes will be issued in a public offering to persons outside the United States in accordance with Regulation S, we believe that the Euro-Notes are not securities 'issued to or held by the public'. . . ."

Most recently, in Fiduciary Trust Global Fund (August 2, 1995), an Irish unit trust proposed to sell shares to accounts established by non-U.S. persons with certain U.S. fiduciaries without counting such accounts toward the 100 U.S. shareholder limit under the Touche Remnant doctrine. In granting no-action relief, the Staff noted that such accounts were excluded from the definition of U.S. person by Section 902(o)(2) of Regulation S.

Touche Remnant doctrine have only two sources for guidance, the Regulation S definition of U.S. person and language set forth in letters from a handful of applicants seeking no-action relief in a period from 1984 through 1988.[17]

Given that offshore funds must limit their U.S. investors to avoid violating Section 7(d) of the 1940 Act, we believe that it is critical that the industry have an objective standard that provides detailed guidance for determining who is a U.S. investor. A subjective approach that would require a fund to weigh the U.S. contacts of each shareholder on an on-going basis in order to determine whether the fund is required to register under the 1940 Act would be unworkable.[18] Accordingly, we ask that the Staff confirm that offshore funds may rely upon the Regulation S definition of U.S. person for this purpose.

C. **Integration of Onshore and Offshore Transactions.** An important predicate of the Touche Remnant doctrine is that a public offering by an offshore fund outside of the United States will not be integrated with a private placement of securities within the United States.[19] When Regulation S was adopted, the Commission also amended Regulation D

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[17] See, e.g. *Touche Remnant*, Merrill Lynch & Co., Inc. (May 12, 1986), G.T. Global Financial Services, Inc. (August 2, 1988), and Prudential-Bache Securities Inc. (August 17, 1987). In these letters, the Staff appears to have implicitly accepted each applicant's definition of a U.S. resident, but did not expressly approve any such definition. These letters generally do not provide the same degree of precision as the Regulation S definition and do not recite a uniform standard. We believe that a substantial number of offshore funds use the Regulation S definition of U.S. person for purposes of establishing their restrictions upon U.S. investors.

[18] In Mercury Asset Management (Apr. 16, 1993), the Staff stated that the Regulation S definition of U.S. person would generally, though not in all cases, be used in determining the extra-territorial reach of the Investment Advisers Act of 1940. This approach seems to require an investment adviser to undertake some analysis of the U.S. contacts of its clients. We note that an investment adviser is likely to have more information regarding the clients for whom it provides advisory services than an offshore fund will have regarding its shareholders.

[19] In *Touche Remnant*, the Staff based its conclusions in part on the premise that the offering to be made in the United States was a private placement made in compliance with the provisions of Rule 506 under Regulation D. One aspect of compliance with Rule 506 is determining whether offerings must be integrated in accordance with Rule 502(a) under Regulation D.

While at least one early no-action letter under the Touche Remnant doctrine, KBS International Ltd. (March 18, 1985), stated that onshore and offshore offers would be integrated if U.S. jurisdictional means were used directly or indirectly in connection with the offshore offer, the Staff subsequently granted no-action relief in numerous letters involving limited use of U.S. jurisdictional means in connection with the foreign offering (e.g. *Merrill Lynch*). These letters typically contemplated that certain procedures designed to preclude redistribution of the offshore funds' shares in the United States would be used. The applicant's letter in *G.T. Global* provides a detailed description of such to provide that, "[g]enerally, transactions otherwise meeting the requirements of an exemption will not be integrated with simultaneous offerings being made outside the United States in compliance with Regulation S."[20] We believe that there is no doubt that for 1933 Act purposes, offshore transactions complying with Regulation S will not be integrated with a U.S. private placement. However we believe that there is unnecessary ambiguity as to whether the same principles are available to offshore funds for purposes of the Touche Remnant doctrine and Section 7(d) of the 1940 Act.[21]

In light of the foregoing, we ask the Staff to confirm our view that, in the absence of a plan or scheme to evade applicable law, a public offering outside the United States by an offshore fund relying upon the Touche Remnant doctrine will not be integrated with a private placement inside the United States so long as the offshore offering is conducted in compliance with Regulation S.

If you should have any questions concerning the above, please feel free to call me at (617) 570-1167 or Elizabeth Shea Fries at (617) 570-1559.

Sincerely yours,

Geoffrey R.T. Kenyon

cc: Elizabeth Shea Fries, Esq.
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procedures. In a number of letters, the applicants have cited 1933 Act Release No. 4708 (July 9, 1964) for the proposition that the onshore and offshore offerings should not be integrated. See, e.g., *G.T. Global*. In the Regulation S Adopting Release, the Commission stated, "reliance upon Securities Act Release 4708 . . . and the no-action and interpretative letters relating thereto is not appropriate for offerings of securities commencing after the ninetieth day following publication of this release in the Federal Register." (Citation omitted.) This statement creates some question as to the continuing validity of letters such as *G.T. Global*.

20 See Note to Rule 502(a).

21 This ambiguity arises primarily from *Win Global*, which stated that the Staff has not expressed an opinion regarding the status of a foreign investment company under Section 7(d) making an offshore offering in reliance upon Regulation S.

Investor Publications

Guide to Broker-Dealer Registration

Division of Trading and Markets[1]
U.S. Securities and Exchange Commission
April 2008

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I. INTRODUCTION

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The Securities Exchange Act of 1934 ("Exchange Act" or "Act") governs the way in which the nation's securities markets and its brokers and dealers operate. We have prepared this guide to summarize some of the significant provisions of the Act and its rules. You will find information about whether you need to register as a broker-dealer and how you can register, as well as the standards of conduct and the financial responsibility rules that broker-dealers must follow.

CAUTION — MAKE SURE YOU FOLLOW ALL LAWS AND RULES

Although this guide highlights certain provisions of the Act and our rules, it is not comprehensive. Brokers and dealers, and their associated persons, must comply with all applicable requirements, including those of the U.S. Securities and Exchange Commission ("SEC" or "Commission"), as well as the requirements of any self-regulatory organizations to which the brokers and dealers belong, and not just those summarized here.

The SEC staff stands ready to answer your questions and help you comply with our rules. After reading this guide, if you have questions, please feel free to contact the Office of Interpretation and Guidance at (202) 551-5777 (e-mail tradingandmarkets@sec.gov) or the Regional Office of the SEC in your area. You will find a list of useful phone numbers at the end of this guide, or on the SEC's website at www.sec.gov/contact.shtml.

You may wish to consult with a private lawyer who is familiar with the federal securities laws, to assure that you comply with all laws and regulations. The SEC staff cannot act as an individual's or broker-dealer's lawyer. While the staff attempts to provide guidance by telephone to individuals who are making inquiries, the guidance is informal and not binding. Formal guidance may be sought through a written inquiry that is consistent with the SEC's guidelines for no-action, interpretive, and exemptive requests.

II. WHO IS REQUIRED TO REGISTER

Most "brokers" and "dealers" must register with the SEC and join a "self-regulatory organization," or SRO. This section covers the factors that determine whether a person is a broker or dealer. It also describes the types of brokers and dealers that do not have to register with the SEC. Self-regulatory organizations are described in Part III, below.

A note about banks: The Exchange Act also contains special provisions relating to brokerage and dealing activities of banks. Please see Sections 3(a)(4)(B) and 3(a)(5)(C) and related provisions, and consult with counsel. Aspects of bank dealer activity are discussed in a publication issued by the SEC's Division of Trading and Markets, entitled "Staff Compliance Guide to Banks on Dealer Statutory Exceptions and Rules," which is available on the SEC's website at: http://www.sec.gov/divisions/marketreg/bankdealerguide.htm. Bank brokerage activity is addressed in Regulation R, which was adopted jointly by the Commission and the Board of Governors of the Federal Reserve System. *See* Exchange Act Release No. 56501 (September 24, 2007) http://www.sec.gov/rules/final/2007/34-56501.pdf.

A. Who is a "Broker"

Section 3(a)(4)(A) of the Act generally defines a "broker" broadly as

> any person engaged in the business of effecting transactions in securities for the account of others.

Sometimes you can easily determine if someone is a broker. For instance, a person who executes transactions for others on a securities exchange clearly is a broker. However, other situations are less clear. For example, each of the following individuals and businesses may need to register as a broker, depending on a number of factors:

- "finders," "business brokers," and other individuals or entities that engage in the following activities:

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  - Finding investors or customers for, making referrals to, or splitting commissions with registered broker-dealers, investment companies (or mutual funds, including hedge funds) or other securities intermediaries;
  - Finding investment banking clients for registered broker-dealers;
  - Finding investors for "issuers" (entities issuing securities), even in a "consultant" capacity;
  - Engaging in, or finding investors for, venture capital or "angel" financings, including private placements;
  - Finding buyers and sellers of businesses (i.e., activities relating to mergers and acquisitions where securities are involved);
- investment advisers and financial consultants;
- foreign broker-dealers that cannot rely on Rule 15a-6 under the Act (discussed below);
- persons that operate or control electronic or other platforms to trade securities;
- persons that market real-estate investment interests, such as tenancy-in-common interests, that are securities;
- persons that act as "placement agents" for private placements of securities;
- persons that market or effect transactions in insurance products that are securities, such as variable annuities, or other investment products that are securities;
- persons that effect securities transactions for the account of others for a fee, even when those other people are friends or family members;
- persons that provide support services to registered broker-dealers; and
- persons that act as "independent contractors," but are not "associated persons" of a broker-dealer (for information on "associated persons," see below).

In order to determine whether any of these individuals (or any other person or business) is a broker, we look at the activities that the person or business actually performs. You can find analyses of various activities in the decisions of federal courts and our own no-action and interpretive letters. Here are some of the questions that you should ask to determine whether you are acting as a broker:

- Do you participate in important parts of a securities transaction, including solicitation, negotiation, or execution of the transaction?
- Does your compensation for participation in the transaction depend upon, or is it related to, the outcome or size of the transaction or deal? Do you receive trailing commissions, such as 12b-1 fees? Do you receive any other transaction-related compensation?
- Are you otherwise engaged in the business of effecting or facilitating securities transactions?
- Do you handle the securities or funds of others in connection with securities transactions?

A "yes" answer to any of these questions indicates that you may need to register as a broker.

B. Who is a "Dealer"

Unlike a broker, who acts as agent, a dealer acts as principal. Section 3(a)(5)(A) of the Act generally defines a "dealer" as:

> any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise.

The definition of "dealer" does not include a "trader," that is, a person who buys and sells securities for his or her own account, either individually or in a fiduciary capacity, but not as part of a regular business. Individuals who buy and sell securities for themselves generally are considered traders and not dealers.

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Sometimes you can easily tell if someone is a dealer. For example, a firm that advertises publicly that it makes a market in securities is obviously a dealer. Other situations can be less clear. For instance, each of the following individuals and businesses may need to register as a dealer, depending on a number of factors:

- a person who holds himself out as being willing to buy and sell a particular security on a continuous basis;
- a person who runs a matched book of repurchase agreements; or
- a person who issues or originates securities that he also buys and sells.

Here are some of the questions you should ask to determine whether you are acting as a dealer:

- Do you advertise or otherwise let others know that you are in the business of buying and selling securities?
- Do you do business with the public (either retail or institutional)?
- Do you make a market in, or quote prices for both purchases and sales of, one or more securities?
- Do you participate in a "selling group" or otherwise underwrite securities?
- Do you provide services to investors, such as handling money and securities, extending credit, or giving investment advice?
- Do you write derivatives contracts that are securities?

A "yes" answer to any of these questions indicates that you may need to register as a dealer.

C. What To Do If You Think You May Be a Broker or a Dealer

If you are doing, or may do, any of the activities of a broker or dealer, you should find out whether you need to register. Information on the broker-dealer registration process is provided below. If you are not certain, you may want to review SEC interpretations, consult with private counsel, or ask for advice from the SEC's Division of Trading and Markets by calling (202) 551-5777 or by sending an e-mail to tradingandmarkets@sec.gov. (Please be sure to include your telephone number.)

Note: If you will be acting as a "broker" or "dealer," you must not engage in securities business until you are properly registered. If you are already engaged in the business and are not yet registered, you should cease all activities until you are properly registered. For further information, please see Part II.D and Part III, below.

D. Brokers and Dealers Generally Must Register with the SEC

Section 15(a)(1) of the Act generally makes it unlawful for any broker or dealer to use the mails (or any other means of interstate commerce, such as the telephone, facsimiles, or the Internet) to "effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security" unless that broker or dealer is registered with the Commission in accordance with Section 15(b) of the Act. There are a few exceptions to this general rule that we discuss below. In addition, we discuss the special registration requirements that apply to broker-dealers of government and municipal securities, including repurchase agreements, below.

1. "Associated Persons" of a Broker-Dealer

We call individuals who work for a registered broker-dealer "associated persons." This is the case whether such individuals are employees, independent contractors, or are otherwise working with a broker-dealer. These individuals may also be called "stock brokers" or "registered representatives." Although associated persons usually do not have to register separately with the SEC, they must be properly supervised by a currently registered broker-dealer. They may also have to register with the self-regulatory organizations of which their employer is a member — for example, the Financial Industry Regulatory Authority, Inc. ("FINRA") (f/k/a the National Association of Securities Dealers, Inc. ("NASD")) or a national securities exchange. To the extent that associated persons engage in securities activities outside of the supervision of their broker-dealer, they would have to register separately as broker-dealers. Part III, below, provides a discussion of how to register as a broker-dealer.

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We do not differentiate between employees and other associated persons for securities law purposes. Broker-dealers must supervise the securities activities of their personnel regardless of whether they are considered "employees" or "independent contractors" as defined under state law. *See*, for example, *In the matter of William V. Giordano*, Securities Exchange Act Release No. 36742 (January 19, 1996).

The law also does not permit unregistered entities to receive commission income on behalf of a registered representative. **For example, associated persons cannot set up a separate entity to receive commission checks.** An unregistered entity that receives commission income in this situation must register as a broker-dealer. *See*, for example, *Wolff Juall Investments, LLC* (May 17, 2005). Under certain circumstances, unregistered entities may engage in payroll administration services involving broker-dealers. *See*, for example, letter re: *ADP TotalSource, Inc.* (December 4, 2007). In those circumstances, the broker-dealer employer generally hires and supervises all aspects of the employees' work and uses the payroll and benefits administrator merely as a means to centralize personnel services.

2. Intrastate Broker-Dealers

A broker-dealer that conducts all of its business in one state does not have to register with the SEC. (State registration is another matter. *See* Part III, below.) The exception provided for intrastate broker-dealer activity is very narrow. To qualify, all aspects of all transactions must be done within the borders of one state. This means that, without SEC registration, a broker-dealer cannot participate in any transaction executed on a national securities exchange.

A broker-dealer that otherwise meets the requirements of the intrastate broker-dealer exemption would not cease to qualify for the intrastate broker-dealer exemption solely because it has a website that may be viewed by out-of-state persons, so long as the broker-dealer takes measures reasonably designed to ensure that its business remains exclusively intrastate. These measures could include the use of disclaimers clearly indicating that the broker-dealer's business is exclusively intrastate and that the broker-dealer can only act for or with, and provide broker-dealer services to, a person in its state, as long as the broker-dealer does not provide broker-dealer services to persons that indicate they are, or that the broker-dealer has reason to believe are, not within the broker-dealer's state of residence.

These measures are not intended to be exclusive. A broker-dealer could adopt other measures reasonably designed to ensure that it does not provide broker-dealer services to persons that are not within the same state as the broker-dealer. However, an intermediary's business would not be "exclusively intrastate" if it sold securities or provided any other broker-dealer services to a person that indicates that it is, or that the broker-dealer has reason to believe is, not within the broker-dealer's state of residence.

For additional information regarding the use of the Internet by intrastate broker-dealers, see https://www.sec.gov/rules/final/2016/33-10238.pdf.

A word about municipal and government securities. There is no intrastate exception from registration for municipal securities dealers or government securities brokers and dealers.

3. Broker-Dealers that Limit their Business to Excluded and Exempted Securities

A broker-dealer that transacts business *only* in commercial paper, bankers' acceptances, and commercial bills does not need to register with the SEC under Section 15(b) or any other section of the Act. On the other hand, persons transacting business only in certain "exempted securities," as defined in Section 3(a)(12) of the Act, do not have to register under Section 15(b), but may have to register under other provisions of the Act. For example, some broker-dealers of government securities, which are "exempted securities," must register as government securities brokers or dealers under Section 15C of the Act, as described in Part II.E, below.

4. Broker-Dealers Must Register Before Selling Unregistered Securities – Including Private Placements (or Regulation D offerings)

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A security sold in a transaction that is exempt from registration under the Securities Act of 1933 (the "1933 Act") is not necessarily an "exempted security" under the Exchange Act. **For example, a person who sells securities that are exempt from registration under Regulation D of the 1933 Act must nevertheless register as a broker-dealer.** In other words, "placement agents" are not exempt from broker-dealer registration.

5. Issuer's "Exemption" and Associated Persons of Issuers *(Rule 3a4-1)*

Issuers generally are not "brokers" because they sell securities for their own accounts and not for the accounts of others. Moreover, issuers generally are not "dealers" because they do not buy and sell their securities for their own accounts as part of a regular business. Issuers whose activities go beyond selling their own securities, however, need to consider whether they would need to register as broker-dealers. This includes issuers that purchase their securities from investors, as well as issuers that effectively operate markets in their own securities or in securities whose features or terms can change or be altered. The so-called issuer's exemption does not apply to the personnel of a company who routinely engage in the business of effecting securities transactions for the company or related companies (such as general partners seeking investors in limited partnerships). The employees and other related persons of an issuer who assist in selling its securities may be "brokers," especially if they are paid for selling these securities and have few other duties.

Exchange Act Rule 3a4-1 provides that an associated person (or employee) of an issuer who participates in the sale of the issuer's securities would not have to register as a broker-dealer if that person, at the time of participation: (1) is not subject to a "statutory disqualification," as defined in Section 3(a)(39) of the Act; (2) is not compensated by payment of commissions or other remuneration based directly or indirectly on securities transactions; (3) *is not an associated person of a broker or dealer*; and (4) limits its sales activities as set forth in the rule.

Some issuers offer dividend reinvestment and stock purchase programs. Under certain conditions, an issuer may purchase and sell its own securities through a dividend reinvestment or stock purchase program without registering as a broker-dealer. These conditions, regarding solicitation, fees and expenses, and handling of participants' funds and securities, are explained in Securities Exchange Act Release No. 35041 (December 1, 1994), 59 FR 63393 ("1994 STA Letter"). Although Regulation M[2] replaced Rule 10b-6 and superseded the 1994 STA Letter, the staff positions taken in this letter regarding the application of Section 15(a) of the Exchange Act remain in effect. *See* 17 CFR 242.102(c) and Securities Exchange Act Release No. 38067 (December 20, 1996), 62 FR 520, 532 n.100 (January 3, 1997).

6. Foreign Broker-Dealer Exemption *(Rule 15a-6)*

The SEC generally uses a territorial approach in applying registration requirements to the international operations of broker-dealers. Under this approach, all broker-dealers physically operating within the United States that induce or attempt to induce securities transactions must register with the SEC, even if their activities are directed only to foreign investors outside of the United States. In addition, foreign broker-dealers that, from outside of the United States, induce or attempt to induce securities transactions by any person in the United States, or that use the means or instrumentalities of interstate commerce of the United States for this purpose, also must register. This includes the use of the internet to offer securities, solicit securities transactions, or advertise investment services to U.S. persons. *See* Securities Exchange Act Release No. 39779 (March 23, 1998) http://www.sec.gov/rules/interp/33-7516.htm.

Foreign broker-dealers that limit their activities to those permitted under Rule 15a-6 of the Act, however, may be exempt from U.S. broker-dealer registration. Foreign broker-dealers that wish to rely on this exemption should review Securities Exchange Act Release No. 27017 (effective August 15, 1989), 54 FR 30013, to determine whether they meet the conditions of Rule 15a-6. *See also* letters re: *Securities Activities of U.S.-Affiliated Foreign Dealers* (April 9 and April 28, 1997). In addition, in April 2005, the Division of Market Regulation staff issued responses to frequently asked questions concerning Rule 15a-6 in relation to Regulation AC. *See* http://www.sec.gov/divisions/marketreg/mregacfaq0803.htm#partb. (Regulation AC is discussec below.)

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E. Requirements Regarding Brokers and Dealers of Government and Municipal Securities, including Repurchase Agreements

Broker-dealers that limit their activity to government or municipal securities require specialized registration. Those that limit their activity to government securities do not have to register as "general-purpose" broker-dealers under Section 15(b) of the Act. General-purpose broker-dealers that conduct a government securities business, however, must note this activity on their Form BD. (Form BD is discussed below.) All firms that are brokers or dealers in government securities must comply with rules adopted by the Secretary of the Treasury, as well as SEC rules.

Firms that limit their securities business to buying and selling municipal securities for their own account (municipal securities dealers) must register as general-purpose broker-dealers. If, however, these entities are banks or meet the requirements of the intrastate exemption discussed in Part II.D.2. above, they must register as municipal securities dealers. Municipal securities brokers (other than banks) must register as general-purpose broker-dealers unless they qualify for the intrastate exception. *See* Part II.D.2 above.

Firms that run a matched book of repurchase agreements or other stock loans are considered dealers. Because a "book running dealer" holds itself out as willing to buy and sell securities, and is thus engaged in the business of buying and selling securities, it must register as a broker-dealer.

F. Special Rules That Apply to Banks and Similar Financial Institutions

Note: Banks, thrifts, and other financial institutions should be aware that the Commission has adopted rules that may affect them. *See* Regulation R, Securities Exchange Act Release No. 34-56501 (Sept. 24, 2007), 72 FR 56514 (Oct. 3, 2007), www.sec.gov/rules/final/2007/34-56501.pdf and Securities Exchange Act Release No. 34-56502 (Sept. 24, 2007) 72 FR 56562 (Oct. 3, 2007), www.sec.gov/rules/final/2007/34-56502.pdf.

Banks. Prior to the enactment of the "Gramm-Leach-Bliley Act" ("GLBA") in 1999, U.S. banks were excepted from the definitions of "broker" and "dealer" under the Act. The GLBA amended the Exchange Act, and banks now have certain targeted exceptions and exemptions from broker-dealer registration. Currently, as a result of Commission rulemaking, banks are undergoing a phase-in period for compliance with the new law. Since October 1, 2003, banks that buy and sell securities must consider whether they are "dealers" under the federal securities laws. The Division of Trading and Markets has issued a special compliance guide for banks, entitled "Staff Compliance Guide to Banks on Dealer Statutory Exceptions and Rules," which is available on the SEC's website at: http://www.sec.gov/divisions/marketreg/bankdealerguide.htm. Bank brokerage activity is addressed in Regulation R, which was adopted jointly by the Commission and the Board of Governors of the Federal Reserve System. *See* Exchange Act Release No. 56501 (September 24, 2007) (which can be found at http://www.sec.gov/rules/final/2007/34-56501.pdf).

The bank exceptions and exemptions only apply to banks, and not to related entities. It is important to note that exceptions applicable to banks under the Exchange Act, as amended by the GLBA, are **not** applicable to other entities, including bank subsidiaries and affiliates, that are not themselves banks. As such, subsidiaries and affiliates of banks that engage in broker-dealer activities are required to register as broker-dealers under the Act. Also, banks that act as municipal securities dealers or as government securities brokers or dealers continue to be required to register under the Act.

Thrifts. By statute, thrifts (savings associations) have the same status as banks, and may avail themselves of the same targeted exceptions and exemptions from broker-dealer registration as banks. (For further information, *See* the "Staff Compliance Guide to Banks on Dealer Statutory Exceptions and Rules," noted above.) As with banks, it is important to note that exceptions and exemptions applicable to thrifts are **not** applicable to other entities, including subsidiaries and affiliates that are not thrifts. As such, subsidiaries and affiliates of thrifts that engage in broker-dealer activities are required to register as broker-dealers under the Act.

Credit Unions and Financial Institution "Networking" Arrangements. The exceptions and e[xemptions] applicable to banks under the Exchange Act do not apply to other kinds of financial institutions, unions. The SEC staff, however, has permitted certain financial institutions, such as credit unions, to make

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securities available to their customers without registering as broker-dealers. This is done through "networking" arrangements, where an affiliated or third-party broker-dealer provides brokerage services for the financial institution's customers, according to conditions stated in no-action letters and NASD Rule 2350.

Under a networking arrangement, financial institutions can share in the commissions generated by their referred customers, under certain conditions. The financial institution engaging in such networking must be in strict compliance with applicable law and Commission staff guidance. *See*, for example, letter re: *Chubb Securities Corporation* (November 24, 1993) and NASD Rule 2350 (applicable to broker-dealers that enter into networking arrangements with banks, thrifts, and credit unions).

G. Insurance Agency Networking

The SEC staff has permitted insurance agencies to make insurance products that are also securities (such as variable annuities) available to their customers without registering as broker-dealers under certain conditions. This again is done through "networking" arrangements, where an affiliated or third-party broker-dealer provides brokerage services for the insurance agency's customers, according to conditions stated in no-action letters. These arrangements are designed to address the difficulties of dual state and federal laws applicable to the sale of these products. Through networking arrangements, insurance agencies can share in the commissions generated by their referred customers under certain conditions. Insurance agencies engaging in such networking must be in strict compliance with applicable law and Commission staff guidance. Insurance companies should consult the letter re: *First of America Brokerage Services, Inc.* (September 28, 1995). Those interested in structuring such an arrangement should contact private counsel or the SEC staff for further information.

Notably, insurance networking arrangements are limited to insurance products that are also securities. They do not encompass sales of mutual funds and other securities that do not present the same regulatory difficulties. *See* letter re: *Lincoln Financial Advisors Corp.* (February 20, 1998).

H. Real Estate Securities and Real Estate Brokers/Agents

The offer of real estate as such, without any collateral arrangements with the seller or others, does not involve the offer of a security. When the real estate is offered in conjunction with certain services, however, it may constitute an investment contract, and thus, a security. *See generally*, Securities Act Release No. 5347 (Jan. 4, 1973) (providing guidelines as to the applicability of the federal securities laws to offers and sales of condominiums or units in a real estate development).

There is no general exception from the broker-dealer registration requirements for licensed real estate brokers or agents who engage in the business of effecting transactions in real estate securities. In the past, the Division staff has granted no-action relief from the registration requirements to licensed real estate personnel that engage in limited activities with respect to the sale of condominium units coupled with an offer or agreement to perform or arrange certain rental or other services for the purchaser. The relief provided in these letters is limited solely to their facts and should not be relied upon for activities relating to sales of other types of real estate securities, including tenants-in-common interests in real property. *See generally*, NASD Notice to Members 05-18, http://www.finra.org/sites/default/files/NoticeDocument/p013455.pdf (addressing tenants-in-common interests in real property).

I. Broker-Dealer Relationships with Affinity Groups

Broker-dealers may enter into arrangements to offer services to members of certain non-profit groups, including civic organizations, charities, and educational institutions that rely upon private donations. These arrangements are subject to certain conditions to ensure that the organizations, or "affinity groups," do not develop a salesman's stake with respect to the sale of securities. *See*, for example, letter re: *Attkisson, Carter & Akers* (June 23, 1998).

III. HOW TO REGISTER AS A BROKER-DEALER

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A broker-dealer may not begin business until:

- **it has properly filed Form BD, and the SEC has granted its registration;**
- **it has become a member of an SRO;**
- **it has become a member of SIPC, the Securities Investor Protection Corporation;**
- **it complies with all applicable state requirements; and**
- **its "associated persons" have satisfied applicable qualification requirements.**

A. Form BD

If a broker-dealer does not qualify for any of the exceptions or exemptions outlined in the sections above, it must register with the Commission under Section 15(b) of the Act. Broker-dealers register by filing an application on Form BD, which you may obtain from the SEC's webpage at http://www.sec.gov/about/forms/formbd.pdf or through the SEC's Publications Office at (202) 551-4040. You also use Form BD to:

- apply for membership in an SRO, such as FINRA or a registered national securities exchange;
- give notice that you conduct government securities activities; or
- apply for broker-dealer registration with each state in which you plan to do business.

Form BD asks questions about the background of the broker-dealer and its principals, controlling persons, and employees. The broker-dealer must meet the statutory requirements to engage in a business that involves high professional standards, and quite often includes the more rigorous responsibilities of a fiduciary.

To apply for registration, you must file one executed copy of Form BD through the Central Registration Depository ("CRD"), which is operated by FINRA. (The only exception is for banks registering as municipal securities dealers, which file Form MSD directly with the SEC and with their appropriate banking regulator.) Form BD contains additional filing instructions. The SEC does not charge a filing fee, but the SROs and the states may. Applicants that reside outside the U.S. must also appoint the SEC as agent for service of process using a standard form. Incomplete applications are not considered "filed" and will be returned to the applicant for completion and re-submission.

Within 45 days of filing a completed application, the SEC will either grant registration or begin proceedings to determine whether it should deny registration. An SEC registration may be granted with the condition that SRO membership must be obtained. The SROs have independent membership application procedures and are not required to act within 45 days of the filing of a completed application. In addition, state registrations may be required. A broker-dealer must comply with relevant state law as well as federal law and applicable SRO rules. Timeframes for registration with individual states may differ from the federal and SRO timeframes. As such, when deciding to register as a broker-dealer, it is important to plan for the time required for processing Federal, state, and SRO registration or membership applications.

Duty to update Form BD. A registered broker-dealer must keep its Form BD current. Thus, it must promptly update its Form BD by filing amendments whenever the information on file becomes inaccurate or incomplete for any reason.

Prohibited Broker-Dealer Names. **Title 18, Section 709 of the United States Code makes it a criminal offense to use the words "National," "Federal," "United States," "Reserve," or "Deposit Insurance" in the name of a person or organization in the brokerage business, unless otherwise allowed by federal law. Further, a broker-dealer name that is otherwise materially misleading would become subject to scrutiny under Exchange Act Section 10(b), and Rule 10b-5 thereunder, the general antifraud rules, and any other applicable provisions.**

B. SRO Membership (Section 15(b)(8) and Rule 15b9-1)

Before it begins doing business, a broker-dealer must become a member of an SRO. SROs assist the SEC in regulating the activities of broker-dealers. FINRA and the national securities exchanges are all S

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dealer restricts its transactions to the national securities exchanges of which it is a member and meets certain other conditions, it may be required only to be a member of those exchanges. If a broker-dealer effects securities transactions other than on a national securities exchange of which it is a member, however, including any over-the-counter business, it must become a member of FINRA, unless it qualifies for the exemption in Rule 15b9-1. FINRA's webpage at www.finra.org provides detailed information on the FINRA membership process. You may also wish to consult the web pages of the individual exchanges for additional information.

Firms that engage in transactions in municipal securities must also comply with the rules of the Municipal Securities Rulemaking Board, or MSRB. The MSRB is an SRO that makes rules governing transactions in municipal securities, but, unlike other SROs, it does not enforce compliance with its rules. Compliance with MSRB rules is monitored and enforced by FINRA and the SEC (in the case of broker-dealers), and the Federal bank regulators and the SEC (in the case of banks). You may wish to consult the MSRB's website at www.msrb.org for additional information, or you can call the MSRB at (703) 797-6600.

C. SIPC Membership

Every registered broker-dealer must be a member of the Securities Investor Protection Corporation, or SIPC, unless its principal business is conducted outside of the United States or consists exclusively of the sale or distribution of investment company shares, variable annuities, or insurance. Each SIPC member must pay an annual fee to SIPC. SIPC insures that its members' customers receive back their cash and securities in the event of a member's liquidation, up to $500,000 per customer for cash and securities. (Claims for cash are limited to $100,000.) For further information, contact SIPC, 805 15th St., NW, Suite 800, Washington, DC 20005. Telephone: (202) 371-8300, fax: (202) 371-6728, or visit SIPC's website at www.sipc.org.

D. State Requirements

Every state has its own requirements for a person conducting business as a broker-dealer within that state. Each state's securities regulator can provide you with information about that state's requirements. You can obtain contact information for these regulators from the North American Securities Administrators Association, Inc. (NASAA), 750 First Street, NE, Suite 1140, Washington, DC 20002. Telephone: (202) 737-0900, or visit NASAA's website at www.nasaa.org.

E. Associated Persons *(Section 3(a)(18); Rule 15b7-1)*

The Act defines an "associated person" of a broker-dealer as any partner, officer, director, branch manager, or employee of the broker-dealer, any person performing similar functions, or any person controlling, controlled by, or under common control with, the broker-dealer. A broker-dealer must file a Form U-4 with the applicable SRO for each associated person who will effect transactions in securities when that person is hired or otherwise becomes associated. Form U-4 is used to register individuals and to record these individuals' prior employment and disciplinary history.

An associated person who effects or is involved in effecting securities transactions also must meet qualification requirements. These include passing an SRO securities qualification examination. Many individuals take the comprehensive "Series 7" exam. If individuals engage only in activities involving sales of particular types of securities, such as municipal securities, direct participation programs (limited partnerships) or mutual funds, they may wish to take a specialized examination focused on that type of security, instead of the general securities examination. There is also a special exam for assistant representatives, whose activities are limited to accepting unsolicited customer orders for execution by the firm. Supervisory personnel, and those who engage in specialized activities such as options trading, must take additional exams that cover those areas. These examinations require the Series 7 exam as a prerequisite.

You can obtain copies of Form U-4, as well as information on securities qualification examinations, from an SRO. FINRA's website at www.finra.org contains detailed information and guidance for individuals who wish to obtain a series license through FINRA. Also note that individual states have their own licensing and regis[...] requirements, so you should consult with the applicable state securities regulators for further inf

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Note: If you hold a series license, you must be properly associated with a registered broker-dealer to effect securities transactions. It is not sufficient merely to hold a series license when engaging in securities business. If you hold a series license and wish to start an independent securities business, or otherwise wish to effect securities transactions outside of an "associated person" relationship, you would first need to register as a broker-dealer.

F. Successor Broker-Dealer Registration *(Rules 15b1-3, 15Ba2-4, and 15Ca2-3)*

A successor broker-dealer assumes substantially all of the assets and liabilities, and continues the business, of a registered predecessor broker-dealer. A successor broker-dealer must file a new Form BD (or, in special instances, amend the predecessor broker-dealer's Form BD) within 30 days after such succession. The filing should indicate that the applicant is a successor. *See* Securities Exchange Act Release No. 31661 (December 28, 1992), 58 FR 7, which is available on the SEC's website at: http://www.sec.gov/rules/interp/1992/34-31661.pdf. *See* also, the instructions to Form BD.

G. Withdrawal from Registration *(Rule 15b6-1)*; Cancellation of Registration

When a registered broker-dealer stops doing business, it must file a Form BDW (http://www.sec.gov/about/forms/formbdw.pdf) to withdraw its registration with the SEC and with the states and SROs of which it is a member. This form requires the broker-dealer to disclose the amount of any funds or securities it owes customers, and whether it is the subject of any proceedings, unsatisfied judgments, liens, or customer claims. These disclosures help to ensure that a broker-dealer's business is concluded in an orderly manner and that customers' funds and securities are protected. In most cases, a broker-dealer must also file a final FOCUS report. Form BDW may also be used by a broker-dealer to withdraw from membership with particular SROs, or to withdraw from registration with particular states, without withdrawing all of its registrations and memberships.

Form BDW is not considered "filed" unless it is deemed complete by the SEC and the SRO that reviews the filing. The SEC may also cancel a broker-dealer's registration if it finds that the firm is no longer in existence or has ceased doing business as a broker-dealer.

IV. SECURITY FUTURES

Security futures, which are contracts of sale for future delivery of a single security or a narrow-based security index, are regulated as both securities by the SEC and as futures by the Commodity Futures Trading Commission ("CFTC"). As a result, firms that conduct business in security futures must be registered with both the SEC and the CFTC. Federal law permits firms already registered with either the SEC or the CFTC to register with the other agency, for the limited purpose of trading security futures, by filing a notice. Specifically, firms registered as general purpose broker-dealers under Section 15(b) of the Act may "notice" register with the CFTC. Likewise, futures commission merchants and introducing brokers registered with the CFTC may notice register with the SEC. (Section 15(b)(12) of the Act provides a limited exception to this notice registration requirement for certain natural persons who are members of security futures exchanges). However, futures commission merchants or introducing brokers that conduct a business in securities other than security futures must be registered as general-purpose broker-dealers. For more information on this topic, *See* Exchange Act Release No. 44730 (effective August 27, 2001), 66 FR 45138, and 66 FR 43080 (effective September 17, 2001).

V. CONDUCT REGULATION OF BROKER-DEALERS

Broker-dealers, like other securities market participants, must comply with the general "antifraud" provisions of the federal securities laws. Broker-dealers must also comply with many requirements that are designed to maintain high industry standards. We discuss some of these provisions below.

A. Antifraud Provisions *(Sections 9(a), 10(b), and 15(c)(1) and (2))*

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The "antifraud" provisions prohibit misstatements or misleading omissions of material facts, and fraudulent or manipulative acts and practices, in connection with the purchase or sale of securities.[3] While these provisions are very broad, the Commission has adopted rules, issued interpretations, and brought enforcement actions that define some of the activities we consider manipulative, deceptive, fraudulent, or otherwise unlawful.[4] Broker-dealers must conduct their activities so as to avoid these kinds of practices.

1. Duty of Fair Dealing

Broker-dealers owe their customers a duty of fair dealing. This fundamental duty derives from the Act's antifraud provisions mentioned above. Under the so-called "shingle" theory, by virtue of engaging in the brokerage profession (*e.g.*, hanging out the broker-dealer's business sign, or "shingle"), a broker-dealer represents to its customers that it will deal fairly with them, consistent with the standards of the profession. Based on this important representation, the SEC, through interpretive statements and enforcement actions, and the courts, through case law, have set forth over time certain duties for broker-dealers. These include the duties to execute orders promptly, disclose certain material information (*i.e.*, information the customer would consider important as an investor), charge prices reasonably related to the prevailing market, and fully disclose any conflict of interest.

SRO rules also reflect the importance of fair dealing. For example, FINRA members must comply with NASD's Rules of Fair Practice. These rules generally require broker-dealers to observe high standards of commercial honor and just and equitable principles of trade in conducting their business. The exchanges and the MSRB have similar rules.

2. Suitability Requirements

Broker-dealers generally have an obligation to recommend only those specific investments or overall investment strategies that are suitable for their customers. The concept of suitability appears in specific SRO rules such as NASD Rule 2310 and has been interpreted as an obligation under the antifraud provisions of the federal securities laws. Under suitability requirements, a broker-dealer must have an "adequate and reasonable basis" for any recommendation that it makes. Reasonable basis suitability, or the reasonable basis test, relates to the particular security or strategy recommended. Therefore, the broker-dealer has an obligation to investigate and obtain adequate information about the security it is recommending.

A broker-dealer also has an obligation to determine customer-specific suitability. In particular, a broker-dealer must make recommendations based on a customer's financial situation, needs, and other security holdings. This requirement has been construed to impose a duty of inquiry on broker-dealers to obtain relevant information from customers relating to their financial situations and to keep such information current. SROs consider recommendations to be unsuitable when they are inconsistent with the customer's investment objectives.

3. Duty of Best Execution

The duty of best execution, which also stems from the Act's antifraud provisions, requires a broker-dealer to seek to obtain the most favorable terms available under the circumstances for its customer orders. This applies whether the broker-dealer is acting as agent or as principal.

The SRO rules also include a duty of best execution. For example, FINRA members must use "reasonable diligence" to determine the best market for a security and buy or sell the security in that market, so that the price to the customer is as favorable as possible under prevailing market conditions.

4. Customer Confirmation Rule (Rule 10b-10 and MSRB rule G-15)

A broker-dealer must provide its customers, at or before the completion of a transaction, with certain information, including:

- the date, time, identity, price, and number of shares involved;
- its capacity (agent or principal) and its compensation (for agency trades, compensation i commission and whether it receives payment for order flow;[5] and for principal trades, ma

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may be required);

- the source and amount of any third party remuneration it has received or will receive;[6]
- other information, both general (such as, if the broker-dealer is not a SIPC member) and transaction-specific (such as the yield, in most transactions involving debt securities).

A broker-dealer may also be obligated under the antifraud provisions of the Act to disclose additional information to the customer at the time of his or her investment decision.

5. Disclosure of Credit Terms *(Rule 10b-16)*

Broker-dealers must notify customers purchasing securities on credit about the credit terms and the status of their accounts. A broker-dealer must establish procedures for disclosing this information before it extends credit to a customer for the purchase of securities. A broker-dealer must give the customer this information at the time the account is opened, and must also provide credit customers with account statements at least quarterly.

6. Restrictions on Short Sales *(Regulation SHO)*

A "short sale" is generally a sale of a security that the seller doesn't own or for which the seller delivers borrowed shares. Regulation SHO was adopted in 2004 to update short sale regulation in light of numerous market developments since short sale regulation was first adopted in 1938. Compliance with Regulation SHO began on January 3, 2005. Some of the goals of Regulation SHO include:

- Establishing uniform "locate" and "close-out" requirements in order to address problems associated with failures to deliver, including potentially abusive "naked" short selling.

  Locate Requirement: Regulation SHO requires a broker-dealer to have reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due before effecting a short sale order in any equity security. This "locate" must be made and documented prior to effecting the short sale. Market makers engaged in bona fide market making are exempted from the "locate" requirement.

  "Close-out" Requirement: Regulation SHO imposes additional delivery requirements on broker-dealers for securities in which there are a relatively substantial number of extended delivery failures at a registered clearing agency ("threshold securities"). For instance, with limited exception, Regulation SHO requires brokers and dealers that are participants of a registered clearing agency to take action to "close-out" failure-to-deliver positions ("open fails") in threshold securities that have persisted for 13 consecutive settlement days. Closing out requires the broker or dealer to purchase securities of like kind and quantity. Until the position is closed out, the broker or dealer and any broker or dealer for which it clears transactions (for example, an introducing broker) may not effect further short sales in that threshold security without borrowing or entering into a bona fide agreement to borrow the security (known as the "pre-borrowing" requirement).

- Creating uniform order marking requirements for sales of all equity securities. This means that a broker-dealer must mark orders as "long" or "short."

For further information, please see the adopting release for Regulation SHO, as well as Frequently Asked Questions, Key Points, and other related materials at http://www.sec.gov/spotlight/shortsales.htm.

7. Trading During an Offering *(Regulation M)*

Regulation M is designed to protect the integrity of the securities trading market as an independent pricing mechanism by governing the activities of underwriters, issuers, selling security holders, and other participants in connection with a securities offering. These rules are aimed at preventing persons having an interest in an offering from influencing the market price for the offered security in order to facilitate a distribution. The adopting release for Regulation M is available at http://www.sec.gov/rules/final/34-38067.txt.

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Rule 101 of Regulation M generally prohibits underwriters, broker-dealers and other distribution participants from bidding for, purchasing, or attempting to induce any person to bid for or purchase, any security which is the subject of a distribution until the applicable restricted period has ended. An offering's "restricted period" begins either one or five business days (depending on the trading volume value of the offered security and the public float value of the issuer) before the day of the offering's pricing and ends upon completion of the distribution.

Rule 101 contains various exceptions that are designed to permit an orderly distribution of securities and limit disruption in the market for the securities being distributed. For example, underwriters can continue to trade in actively-traded securities of larger issuers (securities with an average daily trading volume, or ADTV, value of $1 million or more and whose issuers have a public float value of at least $150 million). In addition, the following activities, among others, may be excepted from Rule 101, if they meet specified conditions:

- disseminating research reports;
- making unsolicited purchases;
- purchasing a group, or "basket" of 20 or more securities;
- exercising options, warrants, rights, and convertible securities;
- effecting transactions that total less than 2% of the security's ADTV; and
- effecting transactions in securities sold to "qualified institutional buyers."

Rule 102 of Regulation M prohibits issuers, selling security holders, and their affiliated purchasers from bidding for, purchasing, or attempting to induce any person to bid for or purchase, any security which is the subject of a distribution until after the applicable restricted period.

Rule 103 of Regulation M governs passive market making by broker-dealers participating in an offering of a Nasdaq security.

Rule 104 of Regulation M governs stabilization transactions, syndicate short covering activity, and penalty bids.

Rule 105 of Regulation M prevents manipulative short sales prior to pricing an offering by prohibiting the purchase of offering securities if a person sold short the security that is the subject of the offering during the Rule 105 restricted period. The rule contains exceptions for bona fide purchases, separate accounts, and investment companies.

For frequently asked questions about Regulation M, see Staff Legal Bulletin No. 9 at http://www.sec.gov/interps/legal/mrslb9.htm.

8. Restrictions on Insider Trading

The SEC and the courts interpret Section 10(b) and Rule 10b-5 under the Act to bar the use by any person of material non-public information in the purchase or sale of securities, whenever that use violates a duty of trust and confidence owed to a third party. Section 15(f) of the Act specifically requires broker-dealers to have and enforce written policies and procedures reasonably designed to prevent their employees from misusing material non-public information. Because employees in the investment banking operations of broker-dealers frequently have access to material non-public information, firms need to create procedures designed to limit the flow of this information so that their employees cannot use the information in the trading of securities. Broker-dealers can use these information barriers as a defense to a claim of insider trading. Such procedures typically include:

- training to make employees aware of these restrictions;
- employee trading restrictions;
- physical barriers;
- isolation of certain departments; and
- limitations on investment bank proprietary trading.[7]

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9. Restrictions on Private Securities Transactions

NASD Rule 3040 provides that "no person associated with a member shall participate in any manner in a private securities transaction" except in accordance with the provisions of the rule. To the extent that any such transactions are permitted under the rule, prior to participating in any private securities transaction, the associated person must provide written notice to the member firm as described in the rule. If compensation is involved, the member firm must approve or disapprove the proposed transaction, record it in its books and records, and supervise the transaction as if it were executed on behalf of the member firm. Other conditions may also apply. In addition, private securities transactions of an associated person may be subject to an analysis under Exchange Act Section 10(b) and Rule 10b-5, as well as the broker-dealer supervisory provisions of Section 15(f) (described in Part V.A.8, above) and Section 15(b)(4)(E), and other relevant statutory or regulatory provisions.

B. Analysts and Regulation AC

Regulation AC (or Regulation Analyst Certification) requires brokers, dealers, and persons associated with brokers or dealers that publish, distribute, or circulate research reports to include in those reports a certification that the views expressed in the report accurately reflect the analyst's personal views. The report must also disclose whether the analyst received compensation for the views expressed in the report. If the analyst has received related compensation, the broker, dealer, or associated person must disclose its amount, source, and purpose. Regulation AC applies to all brokers and dealers, as well as to those persons associated with a broker or dealer that fall within the definition of "covered person." Regulation AC also requires that broker-dealers keep records of analyst certifications relating to public appearances.

In addition to Commission rules, analyst conduct is governed by SRO rules, such as NASD Rule 2711 and NYSE Rule 472. The SRO rules impose restrictions on analyst compensation, personal trading activities, and involvement in investment banking activities. The SRO rules also include disclosure requirements for research reports and public appearances.

For further information, including investor guidance, SEC releases, and SRO rules, see http://www.sec.gov/divisions/marketreg/securitiesanalysts.htm. In addition, staff responses to frequently asked questions are available at http://www.sec.gov/divisions/marketreg/mregacfaq0803.htm.

C. Trading by Members of Exchanges, Brokers and Dealers *(Section 11(a))*

Broker-dealers that are members of national securities exchanges are subject to additional regulations regarding transactions they effect on exchanges. For example, except under certain conditions, they generally cannot effect transactions on exchanges for their own accounts, the accounts of their associated persons, or accounts that they or their associated persons manage. Exceptions from this general rule include transactions by market makers, transactions routed through other members, and transactions that yield to other orders. Exchange members may wish to seek guidance from their exchange regarding these provisions.

D. Extending Credit on New Issues; Disclosure of Capacity as Broker or Dealer *(Section 11(d))*

Section 11(d)(1) of the Act generally prohibits a broker-dealer that participates in the distribution of a new issue of securities from extending credit to customers in connection with the new issue during the distribution period and for 30 days thereafter. Sales by a broker-dealer of mutual fund shares and variable insurance product units are deemed to constitute participation in the distribution of a new issue. Therefore, purchase of mutual fund shares or variable product units using credit extended or arranged by the broker-dealer during the distribution period is a violation of Section 11(d)(1). However, Exchange Act Rule 11d1-2 permits a broker-dealer to extend credit to a customer on newly sold mutual fund shares and variable insurance product units after the customer has owned the shares or units for 30 days.

Section 11(d)(2) of the Act requires a broker-dealer to disclose in writing, at or before the complReturn to Top
transaction with a customer, whether the broker-dealer is acting in the capacity of broker or dealer with regard to

the transaction.

E. Regulation NMS

Regulation NMS addresses four interrelated topics that are designed to modernize the regulatory structure of the U.S. equity markets: (1) order protection, (2) intermarket access, (3) sub-penny pricing, and (4) market data.

1. The "Order Protection Rule" requires trading centers to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the execution of trades at prices inferior to protected quotations displayed by other trading centers, subject to an applicable exception. To be protected, a quotation must be immediately and automatically accessible.
2. The "Access Rule" requires fair and non-discriminatory access to quotations, establishes a limit on access fees to harmonize the pricing of quotations across different trading centers, and requires each national securities exchange and national securities association to adopt, maintain, and enforce written rules that prohibit their members from engaging in a pattern or practice of displaying quotations that lock or cross automated quotations.
3. The "Sub-Penny Rule" prohibits market participants from accepting, ranking, or displaying orders, quotations, or indications of interest in a pricing increment smaller than a penny, except for orders, quotations, or indications of interest that are priced at less than $1.00 per share.
4. The "Market Data Rules" update the requirements for consolidating, distributing, and displaying market information. In addition, amendments to the joint industry plans for disseminating market information modify the formulas for allocating plan revenues among the self-regulatory organizations and broaden participation in plan governance.

Regulation NMS also updates and streamlines the existing Exchange Act rules governing the national market system previously adopted under Section 11A of the Exchange Act, and consolidates them into a single regulation.

For additional details regarding Regulation NMS, see http://www.sec.gov/rules/final/34-51808fr.pdf and http://www.sec.gov/spotlight/regnms.htm.

F. Order Execution Obligations *(Rules 602-604 of Regulation NMS)*

Broker-dealers that are exchange specialists or Nasdaq market makers must comply with particular rules regarding publishing quotes and handling customer orders. These two types of broker-dealers have special functions in the securities markets, particularly because they trade for their own accounts while also handling orders for customers. These rules, which include the "Quote Rule" and the "Limit Order Display Rule," increase the information that is publicly available concerning the prices at which investors may buy and sell exchange-listed and Nasdaq National Market System securities.

The Quote Rule requires specialists and market makers to provide quotation information to their self-regulatory organization for dissemination to the public. The quote information that the specialist or market maker provides must reflect the best prices at which he is willing to trade (the lowest price the dealer will accept from a customer to sell the securities and the highest price the dealer will pay a customer to purchase the securities). A specialist or market maker may still trade at better prices in certain private trading systems, called electronic communications networks, or "ECNs," without publishing an improved quote. This is true only when the ECN itself publishes the improved prices and makes those prices available to the investing public. Thus, the Quote Rule ensures that the public has access to the best prices at which specialists and market makers are willing to trade even if those prices are in private trading systems.

Limit orders are orders to buy or sell securities at a specified price. The Limit Order Display Rule requires that specialists and market makers publicly display certain limit orders they receive from customers. If the limit order is for a price that is better than the specialist's or market maker's quote, the specialist or market maker must publicly display it. The rule benefits investors because the publication of trading interest at prices that im
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and market makers' quotes present investors with improved pricing opportunities.

G. Regulation ATS: Broker-Dealer Trading Systems

Regulation ATS (17 CFR 242.300 et seq.) provides a means for broker-dealers to operate automated trading platforms, to collect and execute orders in securities electronically, without registering as a national securities exchange under Section 6 of the Exchange Act or as an exempt exchange pursuant to Section 5 of the Act. For purposes of the regulation, an alternative trading system or ATS is any organization, association, person, group of persons, or system that constitutes, maintains, or provides a marketplace or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as defined in Rule 3b-16 under the Exchange Act. *See* 17 CFR 242.300. Further, for purposes of the regulation, an ATS may not set rules governing the conduct of subscribers (other than with respect to the use of the particular trading system), or discipline subscribers other than by exclusion from trading. To the extent that an ATS or the sponsoring broker-dealer seeks to establish conduct or disciplinary rules, the entity may be required to register as a national securities exchange or obtain a Commission exemption from exchange registration based on limited trading volume.

In order to acquire the status of an ATS, a firm must first be registered as a broker-dealer, and it must file an initial operation report with respect to the trading system on Form ATS at least 20 days before commencing operation. The initial operation report must be accurate and kept current. The Commission does not issue approval orders for Form ATS filings; however, the Form ATS is not considered filed unless it complies with all applicable requirements under the Regulation. Regulation ATS contains provisions concerning the system's operations, including: fair access to the trading system; fees charged; the display of orders and the ability to execute orders; system capacity, integrity and security; record keeping and reporting; and procedures to ensure the confidential treatment of trading information.

An ATS must file with the Division of Trading and Markets quarterly reports regarding its operations on Form ATS-R. An ATS must also comply with any applicable SRO rules and with state laws relating to alternative trading systems and relating to the offer or sale of securities or the registration or regulation of persons or entities effecting securities transactions.

Finally, an ATS may not use in its name the word "exchange," or terms similar to the word "exchange," such as the term "stock market." *See* 17 CFR 242.301. For further information on the operation and regulation of alternative trading systems, see the adopting release for Regulation ATS at http://www.sec.gov/rules/final/34-40760.txt.

H. Penny Stock Rules *(Rules 15g-2 through 15g-9, Schedule 15G)*

Most broker-dealers that effect transactions in "penny stocks" have certain enhanced suitability and disclosure obligations to their customers.[8] A penny stock is generally defined as any equity security other than a security that: (a) is an NMS stock (*See* Rule 600(b)(47)) listed on a "grandfathered" national securities exchange, (b) is an NMS stock listed on a national securities exchange or an automated quotation system sponsored by a registered national securities association (including Nasdaq) that satisfies certain minimum quantitative listing standards, (c) has a transaction price of five dollars or more, (d) is issued by a registered investment company or by the Options Clearing Corporation, (e) is a listed security futures product, or (f) is a security whose issuer has met certain net tangible assets or average revenues (*See* Rule 3a51-1). Penny stocks include the equity securities of private companies with no active trading market if they do not qualify for one of the exclusions from the definition of penny stock.

Before a broker-dealer that does not qualify for an exemption[9] may effect a solicited transaction in a penny stock for or with the account of a customer it must: (1) provide the customer with a risk disclosure document, as set forth in Schedule 15G, and receive a signed and dated acknowledgement of receipt of that document from the customer (*See* Rule 15g-2); (2) approve the customer's account for transactions in penny stocks, provide the customer with a suitability statement, and receive a signed a dated copy of that statement from the customer; and (3) receive the customer's written agreement to the transaction (*See* Rule 15g-9). The broker-dealer also must wait at least two business days after sending the customer the risk disclosure document and the suitability stater

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effecting the transaction. In addition, Exchange Act Rules 15g-3 through 15g-6 generally require a broker-dealer to give each penny stock customer:

- information on market quotations and, where appropriate, offer and bid prices;
- the aggregate amount of any compensation received by the broker-dealer in connection with such transaction;
- the aggregate amount of cash compensation that any associated person of the broker-dealer, who is a natural person and who has communicated with the customer concerning the transaction at or prior to the customer's transaction order, other than a person whose function is solely clerical or ministerial, has received or will receive from any source in connection with the transaction; and
- monthly account statements showing the market value of each penny stock held in the customer's account.

I. Privacy of Consumer Financial Information *(Regulation S-P)*

Broker-dealers, including foreign broker-dealers registered with the Commission and unregistered broker-dealers in the United States, must comply with Regulation S-P, (*See* 17 CFR Part 248) even if their consumers are non-U.S. persons or if they conduct their activities through non-U.S. offices or branches.

Regulation S▲P generally requires a broker-dealer to provide its customers with initial, annual and revised notices containing specified information about the broker-dealer's privacy policies and practices. These notices must be clear and conspicuous, and must accurately reflect the broker-dealer's policies and practices. *See* 17 CFR 248.4, 248.5, 248.6 and 248.8. Before disclosing nonpublic personal information about a consumer to a nonaffiliated third party, a broker-dealer must first give a consumer an opt-out notice and a reasonable opportunity to opt out of the disclosure. *See* 17 CFR 248.7 and 248.10. There are exceptions from these notice and opt-out requirements for disclosures to other financial institutions under joint marketing agreements and to certain service providers. *See* 17 CFR 248.13. There also are exceptions for disclosures made for purposes such as maintaining or servicing accounts, and disclosures made with the consent or at the direction of a consumer, or for purposes such as protecting against fraud, reporting to consumer reporting agencies, and providing information to law enforcement agencies. *See* 17 CFR 248.14 and 248.15.

Regulation S▲P also imposes limits on the re-disclosure and re-use of information, and on sharing account number information with nonaffiliated third parties for use in telemarketing, direct mail marketing and email marketing. *See* 17 CFR 248.11 and 248.12. In addition, it includes a safeguards rule that requires a broker-dealer to adopt written policies and procedures for administrative, technical, and physical safeguards to protect customer records and information. *See* 17 CFR 248.30(a). Further, it includes a disposal rule that requires a broker-dealer (other than a broker-dealer registered by notice with the Commission to engage solely in transactions in securities futures) that maintains or possesses consumer report information for a business purpose to take reasonable measures to protect against unauthorized access to or use of the information in connection with its disposal. *See* 17 CFR 248.30(b).

Recently proposed amendments which would further strengthen the privacy protections under Regulation S-P are available at http://www.sec.gov/rules/proposed/2008/34-57427.pdf.

J. Investment Adviser Registration

Broker-dealers offering certain types of accounts and services may also be subject to regulation under the Investment Advisers Act.[10] (An investment adviser is defined as a person who receives compensation for providing advice about securities as part of a regular business.) (*See* Section 202(a)(11) of the Investment Advisers Act .) In general, a broker-dealer whose performance of advisory services is "solely incidental" to the conduct of its business as a broker-dealer and that receives no "special compensation" is excepted from the definition of investment adviser. Thus, for example, a broker-dealer that provides advice and offers fee-based accounts (i.e., accounts that charge an asset-based or fixed fee rather than a commission, mark-up, or mark-d[...] those accounts as advisory because an asset-based fee is considered "special compensation." Return to Top recently proposed rule, a broker-dealer would be required to treat (1) each account over which it exercises investment discretion as an advisory account, unless the investment discretion is granted by a customer on a temporary or limited basis and (2) an account as advisory if the broker-dealer charges a separate fee for, or separately contracts to provide, advisory services. (*See* http://www.sec.gov/rules/proposed/2007/ia-2652.pdf.) Finally, under the same proposed rule, a broker-dealer that is registered under the Exchange Act and registered under the Investment Advisers Act would be an investment adviser solely with respect to those accounts for which it provides services that subject the broker-dealer to the Investment Advisers Act.

VI. ARBITRATION

Pursuant to the rules of self-regulatory organizations, broker-dealers are required to arbitrate disputes with their customers, if the customer chooses to arbitrate. *See e.g.*, NASD Code of Arbitration Procedure for Customer Disputes, Rule 12200; American Stock Exchange, Rule 600; and Chicago Board of Options Exchange, Rule 18.1.

VII. FINANCIAL RESPONSIBILITY OF BROKER-DEALERS

Broker-dealers must meet certain financial responsibility requirements, including:

- maintaining minimum amounts of liquid assets, or net capital;
- taking certain steps to safeguard the customer funds and securities; and
- making and preserving accurate books and records.

A. Net Capital Rule *(Rule 15c3-1)*

The purpose of this rule is to require a broker-dealer to have at all times enough liquid assets to promptly satisfy the claims of customers if the broker-dealer goes out of business. Under this rule, broker-dealers must maintain minimum net capital levels based upon the type of securities activities they conduct and based on certain financial ratios. For example, broker-dealers that clear and carry customer accounts generally must maintain net capital equal to the greater of $250,000 or two percent of aggregate debit items. Broker-dealers that do not clear and carry customer accounts can operate with lower levels of net capital.

B. Use of Customer Balances *(Rule 15c3-2)*

Broker-dealers that use customers' free credit balances in their business must establish procedures to provide specified information to those customers, including:

- the amount due to those customers;
- the fact that such funds are not segregated and may be used by the broker-dealer in its business; and
- the fact that such funds are payable on demand of the customer.

C. Customer Protection Rule *(Rule 15c3-3)*

This rule protects customer funds and securities held by broker-dealers. Under the rule, a broker-dealer must have possession or control of all fully-paid or excess margin securities held for the account of customers, and determine daily that it is in compliance with this requirement. The broker-dealer must also make periodic computations to determine how much money it is holding that is either customer money or obtained from the use of customer securities. If this amount exceeds the amount that it is owed by customers or by other broker-dealers relating to customer transactions, the broker-dealer must deposit the excess into a special reserve bank account for the exclusive benefit of customers. This rule thus prevents a broker-dealer from using customer funds to finance its business.

D. Required Books, Records, and Reports *(Rules 17a-3, 17a-4, 17a-5, 17a-11)*[11]

Broker-dealers must make and keep current books and records detailing, among other things, securities transactions, money balances, and securities positions. They also must keep records for require furnish copies of those records to the SEC on request. These records include e-mail. Broker-de

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with the SEC periodic reports, including quarterly and annual financial statements. The annual statements generally must be certified by an independent public accountant. In addition, broker-dealers must notify the SEC and the appropriate SRO[12] regarding net capital, recordkeeping, and other operational problems, and in some cases file reports regarding those problems, within certain time periods. This gives us and the SROs early warning of these problems.

E. Risk Assessment Requirements *(Rules 17h-1T and 17h-2T)*

Certain broker-dealers must maintain and preserve certain information regarding those affiliates, subsidiaries and holding companies whose business activities are reasonably likely to have a material impact on their own financial and operating condition (including the broker-dealer's net capital, liquidity, or ability to conduct or finance operations). Broker-dealers must also file a quarterly summary of this information. This information is designed to permit the SEC to assess the impact these entities may have on the broker-dealer.

VIII. OTHER REQUIREMENTS

In addition to the provisions discussed above, broker-dealers must comply with other requirements. These include:

- submitting to Commission and SRO examinations;
- participating in the lost and stolen securities program;
- complying with the fingerprinting requirement;
- maintaining and reporting information regarding their affiliates;
- following certain guidelines when using electronic media to deliver information; and
- maintaining an anti-money laundering program.

A. Examinations and Inspections *(Rules 15b2-2 and 17d-1)*

Broker-dealers are subject to examination by the SEC and the SROs. The appropriate SRO generally inspects newly-registered broker-dealers for compliance with applicable financial responsibility rules within six months of registration, and for compliance with all other regulatory requirements within twelve months of registration. A broker-dealer must permit the SEC to inspect its books and records at any reasonable time.

B. Lost and Stolen Securities Program *(Rule 17f-1)*

In general, all broker-dealers must register in the lost and stolen securities program. The limited exceptions include broker-dealers that effect securities transactions exclusively on the floor of a national securities exchange solely for other exchange members and do not receive or hold customer securities, and broker-dealers whose business does not involve handling securities certificates. Broker-dealers must report losses, thefts, and instances of counterfeiting of securities certificates on Form X-17F-1A, and, in some cases, broker-dealers must make inquiries regarding securities certificates coming into their possession. Broker-dealers must file these reports and inquiries with the Securities Information Center (SIC), which operates the program for the SEC. A registration form can be obtained from Securities Information Center, P.O. Box 55151, Boston, MA 02205-5151. For registration and additional information, see the SIC's website at https://www.secic.com.

C. Fingerprinting Requirement *(Rule 17f-2)*

Generally, every partner, officer, director, or employee of a broker-dealer must be fingerprinted and submit his or her fingerprints to the U.S. Attorney General. This requirement does not apply, however, to broker-dealers that sell only certain securities that are not ordinarily evidenced by certificates (such as mutual funds and variable annuities) or to persons who do not sell securities, have access to securities, money or original books and records, and do not supervise persons engaged in such activities. A broker-dealer claiming an exemption must comply with the notice requirements of Rule 17f-2. Broker-dealers may obtain fingerprint cards from their SF submit completed fingerprint cards to the SRO for forwarding to the FBI on behalf of the Attorne

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D. Use of Electronic Media by Broker-Dealers

The Commission has issued two interpretive releases discussing the issues that broker-dealers should consider in using electronic media for delivering information to customers. These issues include the following:

- Will the customer have notice of and access to the communication?
- Will there be evidence of delivery?
- Did the broker-dealer take reasonable precautions to ensure the integrity, confidentiality, and security of any personal financial information?

See Securities Exchange Act Release No. 37182 (May 15, 1996), 61 FR 24644. *See also*, Securities Exchange Act Release No. 39779 (March 23, 1998), 63 FR 14806 (http://www.sec.gov/rules/interp/33-7516.htm).

E. Electronic Signatures (E-SIGN)

Broker-dealers should also consider the impact, if any, that the Electronic Signatures in Global and National Commerce Act (commonly known as E-SIGN), Pub. L. No. 106-229, 114 Stat. 464 (2000) [15 U.S.C. §7001], has on their ability to deliver information to customers electronically.

F. Anti-Money Laundering Program

Broker-dealers have broad obligations under the Bank Secrecy Act ("BSA")[13] to guard against money laundering and terrorist financing through their firms. The BSA, its implementing regulations, and Rule 17a-8 under the Exchange Act require broker-dealers to file reports or retain records relating to suspicious transactions, customer identity, large cash transactions, cross-border currency movement, foreign bank accounts and wire transfers, among other things.

The BSA, as amended by the USA PATRIOT Act, as well as SRO rules (e.g., NASD Rule 3011 and NYSE Rule 445), also requires all broker-dealers to have anti-money laundering compliance programs in place. Firms must develop and implement a written anti-money laundering compliance program, approved in writing by a member of senior management, which is reasonably designed to achieve and monitor the member's ongoing compliance with the requirements of the BSA and its implementing regulations. Under this obligation, firms must:

- establish and implement policies and procedures that can be reasonably expected to detect and cause the reporting of suspicious transactions;
- establish and implement policies, procedures, and internal controls reasonably designed to achieve compliance with the BSA and implementing regulations;
- provide for independent testing for compliance, to be conducted by member personnel or by a qualified outside party;
- designate and identify to the SROs an individual or individuals responsible for implementing and monitoring the day-to-day operations and internal controls of the program and provide prompt notification regarding any change in such designation(s); and
- provide ongoing training for appropriate personnel.

For a compilation of key anti-money laundering laws, rules and guidance applicable to broker-dealers, see Anti-Money Laundering Source Tool http://www.sec.gov/about/offices/ocie/amlsourcetool.htm; see also, FINRA Anti-Money Laundering Issue Center http://www.finra.org/RulesRegulation/IssueCenter/Anti-MoneyLaundering/index.htm. In addition, the Financial Crimes Enforcement Network ("FinCEN"), the division within the Department of the Treasury that administers the BSA, provides useful information for helping financial institutions, including broker-dealers, meet their BSA obligations. *See* FinCEN Web site http://fincen.gov/.

G. Office of Foreign Assets Control

Broker-dealers have an obligation to comply with the sanctions programs administered by the D Return to Top
Treasury's Office of Foreign Assets Control (OFAC). OFAC administers and enforces economic and trade

sanctions based on US foreign policy and national security goals against targeted foreign countries, terrorists, international narcotics traffickers, and those engaged in activities related to the proliferation of weapons of mass destruction.[14] OFAC acts under Presidential wartime and national emergency powers, as well as authority granted by specific legislation, to impose controls on transactions and freeze foreign assets under US jurisdiction.

OFAC's sanctions programs are separate and distinct from, and in addition to, the anti-money laundering requirements imposed under the BSA on broker-dealers.[15] Unlike the BSA, OFAC programs apply to all U.S. persons and are applicable across business lines. OFAC programs are also strict liability programs — there are no safe harbors and no de minimis standards, although having a comprehensive compliance program in place could act as a mitigating factor in any enforcement action. OFAC publishes regulations implementing each of its programs, which include trade restrictions and asset blockings against particular countries and parties tied to terrorism, narcotics trafficking, proliferation of weapons of mass destruction, as well as a number of programs targeting members of certain foreign jurisdictions. As part of its efforts to implement these programs, OFAC publishes a list of Specially Designated Nationals, which is frequently updated on an as-needed basis.[16] In general, OFAC regulations require you to do the following:

- block accounts and other property of specified countries, entities, and individuals;
- prohibit or reject unlicensed trade and financial transactions with specified countries, entities, and individuals; and
- report all blockings and rejections of prohibited transactions to OFAC within ten days of the occurrence and annually.[17]

OFAC has the authority to impose civil penalties of over $1,000,000 per count for violations of its sanctions programs. OFAC has stated that it will take into account the adequacy of your OFAC compliance program when it evaluates whether to impose a penalty if an OFAC violation occurs. To guard against engaging in OFAC prohibited transactions, you should generally follow a best practice of "screening against" the OFAC lists.[18] Consistent with this best practice, you should take care to screen all new accounts, existing accounts, customers and relationships against the OFAC lists, including any updates to the lists. This screening should include originators or recipients of wire and securities transfers.[19]

H. Business Continuity Planning

The Commission, Federal Reserve Board, and Comptroller of the Currency published an interagency *White Paper* emphasizing the importance of core clearing and settlement organizations and establishing guidelines for their capacity and ability to restore operations within a short time of a wide-scale disruption.[20] Separately, the Commission also published a *Policy Statement* urging the organized securities markets to improve their business continuity arrangements,[21] and encouraging SRO-operated markets and electronic communications networks, or ECNs to establish plans to enable the restoration of trading no later than the business day following a wide-scale disruption.

In 2004, NASD and the NYSE adopted rules requiring every member to establish and maintain a business continuity plan, with elements as specified in the rules, and to provide the respective SROs with emergency contact information. *See* NASD Rule 3510 and NYSE Rule 446. *See also*, http://www.sec.gov/rules/sro/nasd/34-49537.pdf.

IX. WHERE TO GET FURTHER INFORMATION

For general questions regarding broker-dealer registration and regulation:

Office of Interpretation and Guidance
Division of Trading and Markets
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

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(202) 551-5777
e-mail: tradingandmarkets@sec.gov

For additional information about how to obtain official publications of SEC rules and regulations, and for on-line access to SEC rules:

Superintendent of Documents
Government Printing Office
Washington, DC 20402-9325
www.gpo.gov

For copies of SEC forms and recent SEC releases,

See www.sec.gov, or contact:

Publications Section
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549
(202) 551-4040

Other useful addresses, telephone numbers, and websites:

SEC's website: www.sec.gov
The SEC's website contains contact numbers for SEC offices in Washington and for the SEC's regional offices: http://www.sec.gov/contact/addresses.htm.

Financial Industry Regulatory Authority
9509 Key West Avenue
Rockville, MD 20850
(301) 590-6500 (call center)
(800) 289-9999 (to check on the registration status of a firm or individual)
www.finra.org

New York Stock Exchange, Inc.
20 Broad Street
New York, NY 10005
(212) 656-3000
www.nyse.com

North American Securities Administrators Association, Inc.
750 First Street, NE, Suite 1140
Washington, DC 20002
(202) 737-0900
www.nasaa.org

Municipal Securities Rulemaking Board
>1900 Duke Street, Suite 600
Alexandria, VA 22314
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We wish to stress that we have published this guide as an introduction to the federal securities laws that apply to brokers and dealers. It only highlights and summarizes certain provisions, and does not relieve anyone from complying with all applicable regulatory requirements. You should not rely on this guide without referring to the actual statutes, rules, regulations, and interpretations.

Endnotes

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[1] The Division of Trading and Markets was known as the Division of Market Regulation from August 7, 1972, until November 14, 2007.

[2] The treatment of dividend (or interest) reinvestment and stock purchase plans is addressed in Rule 102(c) of Regulation M. (*See* Part V.A.7.)

[3] Section 9(a) prohibits particular manipulative practices regarding securities registered on a national securities exchange. Section 10(b) is a broad "catch-all" provision that prohibits the use of "any manipulative or deceptive device or contrivance" in connection with the purchase or sale of any security. Sections 15(c)(1) and 15(c)(2) apply to the over-the-counter markets. Section 15(c)(1) prohibits broker-dealers from effecting transactions in, or inducing the purchase or sale of, any security by means of "any manipulative, deceptive or other fraudulent device," and Section 15(c)(2) prohibits a broker-dealer from making fictitious quotes.

[4] These include Rules 10b-1 through 10b-18, 15c1-1 through 15c1-9, 15c2-1 through 15c2-11, and Regulation M.

[5] In addition, Rule 11Ac1-3 requires broker-dealers to inform their customers, upon opening a new account and annually thereafter, of their policies regarding payment for order flow and for determining where to route a customer's order.

[6] The purpose of this disclosure is to inform the customer of the nature and extent of a broker-dealer's conflict of interest. Broker-dealers are neither required to disclose the precise amount of these payments nor any formula that would allow a customer to calculate this amount. Nevertheless, Rule 10b-10 is not a safe harbor from the anti-fraud provisions. Recent enforcement actions have indicated that failures to disclose the nature and extent of the conflict of interest may violate Section 17(a)(2) of the 1933 Act. See Edward D. Jones & Co., L.P., Securities Exchange Act Release No. 50910 (Dec. 22, 2004); Morgan Stanley DW, Inc., Securities Exchange Act Release No. 48789 (Nov. 17, 2003).

[7] SEC, Report by Division of Market Regulation, Broker-Dealer Policies and Procedures Designed to Segment the Flow and Prevent the Misuse of Material Non-Public Information, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) 84,520 at p. 80, 620-25 (March, 1990).

[8] Rule 15g-1(a)(1) establishes a transaction exemption for brokers or dealers whose commission equivalents, mark-ups, and mark-downs from transactions in penny stocks during each of the immediately preceding three months and during eleven or more of the preceding twelve months, or during the immediately preceding six months, did not exceed five percent of its total commissions, commission equivalents, mark-ups, and mark-downs from transactions in securities during those months.

[9] Exemptions from the requirements of Exchange Act Rules 15g-2 through 15g-6 are provided for non-recommended transactions, broker-dealers doing a minimal business in penny stocks, trades with institutional investors, and private placements. See Rule 15g-1. Rule 15g-9(c) exempts certain transactions from the requirements of Rule 15g-9.

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[10] *See* Certain Broker-Dealers Deemed Not To Be Investment Advisers, Exchange Act Release No. 51523 (April 12, 2005).

[11] Rules 17a-2, 17a-7, 17a-8, 17a-10 and 17a-13 contain additional recordkeeping and reporting requirements that apply to broker-dealers.

[12] When a broker-dealer is a member of more than one SRO, the SEC designates the SRO responsible for examining such broker-dealer for compliance with financial responsibility rules (the "designated examining authority").

[13] The Currency and Foreign Transactions Reporting Act of 1970 (commonly referred to as the "Bank Secrecy Act") is codified at 31 U.S.C. 5311, et seq. The regulations implementing the Bank Secrecy Act are located at 31 CFR Part 103.

[14] A list of countries subject to OFAC sanctions, as well as a list of individuals and companies owned or controlled by, or acting for or on behalf of, targeted counties (collectively called Specially Designated Nationals (SDNs)), is available on the OFAC website: www.treas.gov/ofac.

A summary of OFAC regulations as they apply to the securities industry can be found at the following link: www.treas.gov/offices/enforcement/ofac/regulations/t11facsc.pdf

See also Federal Financial Institutions Examination Council Bank Secrecy Act/Anti-Money Laundering Examination Manual ("FFIEC Manual"), at pages 137-145 (8/24/2007). The FFIEC Manual contains an entire section outlining best practices for OFAC Compliance, including risk matrices. Although that manual is written for the banking community, it provides information which may be useful to broker-dealers.

[15] *See also* FinCEN Interpretive Release No. 2004-02 "Unitary Filing of Suspicious Activity and Blocking Reports," 69 Fed. Reg. 76847 (Dec. 23, 2004).

[16] OFAC offers a RISS feed service as well as an email notice system which pushes out digital information about its programs, including updates to its SDN List. See www.treas.gov/ofac. These may be especially helpful to smaller firms whose OFAC compliance programs are more manual in nature.

[17] You will find forms for blocking and rejection reports on OFAC's website using the following links:

Voluntary blocking report:
www.treas.gov/offices/enforcement/ofac/legal/forms/e_blockreport1.pdf.

Annual blocking report:
www.treas.gov/offices/enforcement/ofac/legal/forms/td902250.pdf.

Voluntary rejection report:
www.treas.gov/offices/enforcement/ofac/legal/forms/e_recjectreport1.pdf

[18] The Financial Industry Regulatory Authority (FINRA) offers a tool that assists firms to search for names on OFAC lists: http://apps.finra.org/RulesRegulation/OFAC/1/Default.aspx.

[19] See also FFIEC Manual at 140 ("[t]he extent to which the bank includes account parties other than accountholders (e.g., beneficiaries, guarantors, principals, beneficial owners, nominee shareholders, directors, signatories, and powers of attorney) in the initial OFAC review during the account opening process, and during subsequent database reviews of existing accounts, will depend on the bank's risk profile and available technology.").

[20] Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial Systems, Securities Exchange Act Release No. 47638 (April 7, 2003), 68 FR 17809 (April 11, 2003), http://www.sec.gov/news/studies/34-47638.htm.

[21] Policy Statement: Business Continuity Planning for Trading Markets, Securities Exchange Ac Return to Top 48545 (September 25, 2003), 68 FR 56656 (October 1, 2003), http://www.sec.gov/rules/policy/34-48545.htm.

Modified: Dec. 12, 2016

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Press Release

SEC Proposes Conditional Exemption for Finders Assisting Small Businesses with Capital Raising

FOR IMMEDIATE RELEASE
2020-248

Washington D.C., Oct. 7, 2020 — The Securities and Exchange Commission today voted to propose a new limited, conditional exemption from broker registration requirements for “finders” who assist issuers with raising capital in private markets from accredited investors. If adopted, the proposed exemption would permit natural persons to engage in certain limited activities involving accredited investors without registering with the Commission as brokers. The proposed exemption seeks to assist small businesses to raise capital and to provide regulatory clarity to investors, issuers, and the finders who assist them.

The proposal would create two classes of finders, Tier I Finders and Tier II Finders, that would be subject to conditions tailored to the scope of their respective activities. The proposed exemption would establish clear lanes for both registered broker activity and limited activity by finders that would be exempt from registration.

“Many small businesses face difficulties raising the capital that they need to grow and thrive, particularly when they are located in places that lack established, robust capital raising networks,” said Chairman Jay Clayton. “Particularly in these ecosystems, finders may play an important role in facilitating capital formation for smaller issuers. There has been significant uncertainty for years, however, about finders’ regulatory status, leading to many calls for Commission action, including from small business advocates, SEC advisory committees and the Department of the Treasury. If adopted, the proposed relief will bring clarity to finders’ regulatory status in a tailored manner that addresses the capital formation needs of certain smaller issuers while preserving investor protections.”

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FACT SHEET
Proposed Exemption from Broker-Dealer Registration for Finders
October 7, 2020

The Commission is proposing to grant a conditional exemption from the broker registration requirements of Section 15(a) of the Exchange Act to permit natural persons to engage in certain limited capital raising activities involving accredited investors. The proposed exemption would create two classes of exempt Finders, Tier I Finders and Tier II Finders, that would be subject to conditions tailored to the scope of their respective activities. Tier I and Tier II Finders would both be permitted to accept transaction-based compensation under the terms of the proposed exemption.

Tier I Finders

A Tier I Finder would be limited to providing contact information of potential investors in connection with only a single capital raising transaction by a single issuer in a 12 month period. A Tier I Finder could not have any contact with a potential investor about the issuer.

Tier II Finders

A Tier II Finder could solicit investors on behalf of an issuer, but the solicitation-related activities would be limited to: (i) identifying, screening, and contacting potential investors; (ii) distributing issuer offering materials to investors; (iii) discussing issuer information included in any offering materials, provided that the Tier II Finder does not provide advice as to the valuation or advisability of the investment; and (iv) arranging or participating in meetings with the issuer and investor.

Conditions for Both Tier I and Tier II Finders

Both Tier I and Tier II Finders would be subject to certain conditions. The proposed exemption for Tier I and Tier II Finders would be available only where:

- the issuer is not required to file reports under Section 13 or Section 15(d) of the Exchange Act;
- the issuer is seeking to conduct the securities offering in reliance on an applicable exemption from registration under the Securities Act;
- the Finder does not engage in general solicitation;
- the potential investor is an “accredited investor” as defined in Rule 501 of Regulation D or the Finder has a reasonable belief that the potential investor is an “accredited investor”;
- the Finder provides services pursuant to a written agreement with the issuer that includes a description of the services provided and associated compensation;
- the Finder is not an associated person of a broker-dealer; and
- the Finder is not subject to statutory disqualification, as that term is defined in Section 3(a)(39) of the Exchange Act, at the time of his or her participation.

A Finder could not rely on this proposed exemption to engage in broker activity beyond the scope of the proposed exemption. Among other things, a Finder could not rely on this proposed exemption to facilitate a registered offering, a resale of securities, or the sale of securities to investors that are not accredited investors or that the Finder does not have a reasonable belief are accredited investors.

Further, a Finder could not (i) be involved in structuring the transaction or negotiating the terms of the offering; (ii) handle customer funds or securities or bind the issuer or investor; (iii) participate in the preparation of any sales materials; (iv) perform any independent analysis of the sale; (v) engage in any “due diligence” activities; (vi) assist or provide financing for such purchases; or (vii) provide advice as to the valuation or financial advisability of the investment.

Additional Conditions for Tier II Finders

Because Tier II Finders could participate in a wider range of activity and have the potential to engage in more offerings with issuers and investors, the Commission has proposed additional, heightened requirements. A Tier II Finder wishing to rely on the proposed exemption would need to satisfy certain disclosure requirements and other conditions. These disclosure requirements, which include a requirement that the Tier II Finder provide appropriate disclosures of the Tier II Finder’s role and compensation, must be made prior to or at the time of the solicitation. Further, the Tier II Finder must obtain from the investor, prior to or at the time of any investment in the issuer’s securities, a dated written acknowledgment of receipt of the required disclosures.

For More Information

The Office of the Advocate for Small Business Capital Formation has prepared a video and a chart showing a comparison of some of the permissible activities, requirements and limitations for Tier I Finders, Tier II Finders, and registered brokers.

What’s Next?

There will be a 30-day comment period for the proposed exemption following publication in the Federal Register.

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Related Materials

- Proposed Exemptive Order
- Educational Resources on Finders Proposed Exemptive Order

Finders: Is the SEC Finally Ready to Clarify this Cloudy Issue for Startups and Other Private Companies?

crowdfundinsider.com/2021/04/174470-finders-is-the-sec-finally-ready-to-clarify-this-cloudy-issue-for-startups-and-other-private-companies/

April 22, 2021 @ 11:30 am

In an effort to address an issue that has frustrated the business community for years, including startups, tech companies, and "finders," the U.S. Securities and Exchange Commission (SEC) published a proposed conditional exemption for finders on October 7, 2020. Under the proposal, people (i.e., finders) seeking to assist companies or issuers in raising capital – for a fee – will have a non-exclusive safe-harbor from the broker-dealer registration requirement under Section 15(a) of the Securities Exchange Act of 1934, as amended.

Since then, however, a new U.S. president has brought in a new leadership team, and the SEC has received a mix of positive and negative comments with respect to the proposal. How Biden's recently confirmed SEC Chair **Gary Gensler** approaches the proposal is a key issue to watch in the coming months.

Background

The question of whether a finder must register as a broker-dealer has been a difficult issue to navigate. As indicated in the new proposal, companies, particularly small businesses, often encounter challenges raising capital. This challenge has provided an opening for finders to help these issuers by introducing them to potential investors. Section 3(a)(4) of the Exchange Act generally defines a broker as "any person engaged in the business of effecting transactions in securities for the account of others." Section 15(a)(1) of the Exchange Act makes it unlawful, generally, for a broker to use any means of interstate commerce to "effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security," unless the broker is registered under the Exchange Act.

As such, the Exchange Act, as a general matter, presents a potential roadblock for finders, that are not registered as broker-dealers, to be compensated for introducing issuers to investors that invest in their private offerings. The uncertainty relates to the fact that the Exchange Act does not provide guidance as to what it means to be "engaged in the business" or "effecting transactions." As such, the SEC has attempted to tackle this issue over the years through a series of no-action letters, which are based on the facts and circumstances associated with each particular letter. The SEC has attempted to provide guidance through these letters by identifying activities and factors, particularly involving the finder's ability to receive transaction-based compensation, that are deemed to be broker-dealer activities. Although the SEC has, in very limited circumstances, granted relief to finders in these letters, it has not provided a set of rules or guidance that provides a uniform answer to the conundrum of whether the finder must be registered as a broker-dealer under the Exchange Act.

“Gray Market” and Potential Penalties

This resultant “gray market,” where companies consider utilizing finders that are not registered broker-dealers, can lead to potential penalties for both the issuer and the finder. As to finders who are engaged in certain activities but not properly registered as a broker-dealer, they can be subject to both civil and criminal penalties. With respect to the issuer utilizing a finder who is not registered as a broker-dealer, it can potentially lose the exemption it relied upon to conduct the private offering, and it can potentially be required to conduct a rescission offering, which could be disastrous.

The SEC’s Exemption Proposal

Under its new proposal, the SEC proposes to exempt two (2) classes of finders, “*Tier I Finders*” and “*Tier 2 Finders*.” The exemptions for Tier I Finders and Tier II Finders would be available only where:

- The finder is a natural person;
- The issuer is not required to file reports under Sections 13 and 15(d) of the Exchange Act;
- The issuer is seeking to conduct a securities offering in reliance upon an applicable exemption from registration under the Securities Act of 1933, as amended;
- The finder does not engage in general solicitation;
- The potential investor is an “accredited investor” as defined in Rule 501 of Regulation D or the finder has a reasonable belief that the potential investor is an “accredited investor”;
- The finder provides services pursuant to a written agreement with the issuer that includes a description of the services provided and associated compensation;
- The finder is not an associated person of a broker-dealer; and
- The finder is not subject to statutory disqualification as defined in Section 3(a)(9) of the Exchange Act, at the time of its participation.

Tier I Finders

Tier I Finders are defined as those finders who meet the general conditions referenced above and whose activity is limited to providing contact information for potential investors in connection with only one capital-raising transaction or offering by a single issuer within a 12-month period. However, the Tier I Finders cannot have any direct contact with the potential investors about the issuer. The proposal would allow Tier I Finders to provide issuers with investor contact information, which may include, among other things, their names, telephone numbers, email addresses, and social media information.

Tier II Finders

Tier II Finders are defined as finders who meet the general conditions referenced above and who engage in additional solicitation-related activities, on behalf of the issuer, that are limited to: (1) identifying, screening and contacting potential investors; (2) distributing issuer offering materials to investors; (3) discussing issuer information included in any offering documents as long as the Tier II Finder does not provide advice as to the valuation or advisability of the investment; and (4) arranging or participating in meetings with the issuer and the investor. Tier II Finders may participate in more than one capital-raising transaction or offering within a 12-month period.

Tier II Finders that seek to rely upon the proposed exemption would need to provide a potential investor, either prior to or at the time of solicitation, disclosure that includes: (1) the Tier II Finder's name; (2) the issuer's name; (3) certain information about the relationship between the issuer and the Tier II Finder; (4) a statement that the Tier II Finder will be compensated for the solicitation activities by the issuer and the terms of such compensation arrangement; (5) any material conflicts of interest resulting from the arrangement or relationship between the Tier II Finder and the issuer and (6) an affirmative written statement acknowledging that the Tier II Finder is acting as an agent of the issuer, is not acting as an associated person of a broker-dealer and is not undertaking a role to act in the investor's best interest.

Under the proposal, the Tier II Finder may deliver such information orally, provided that the oral disclosure is supplemented by written disclosure satisfying the requirements set forth above. Additionally, the Tier II Finder must obtain from the investor, prior to or at the time of any investment in the issuer's securities, a dated written acknowledgment that the investor has received such disclosures.

Tier I Finders and Tier II Finders that comply with the exemption's conditions may receive transaction-based compensation for the limited services described above without registering as a broker under the Exchange Act.

Prohibited Activities

To further limit the scope of the exemption, the proposal prohibits finders (both Tier I Finders and Tier II Finders) from: (1) being involved in structuring the transaction or negotiating the terms of the offering; (2) handling customer funds or securities; (3) binding the issuer or investor, (4) participating in the preparation of any sales materials; (5) performing any independent analysis of the sale; (6) engaging in any “due diligence” activities; (7) assisting or providing financing for such purchases or (8) providing advice as to the valuation or financial advisability of the investment.

What Will the Biden Administration Do?

The SEC received more than 90 comments by the close of the commenting period and, as expected, they reflected a wide variety of opinions. Some commenters praised the proposal for providing regulatory clarity while others criticized it for allowing unregistered finders to conduct broker activities without sufficient investor protection mechanisms.

Given that the proposal was not adopted by the SEC before the end of the Trump administration, it now sits on the Biden administration’s to-do (or not-to-do) list. President Biden’s new SEC Chair Gary Gensler has not expressed a particular view with respect to the proposal. Nevertheless, from a policy perspective, it’s worth noting that during his testimony before the Senate Banking Committee, Mr. Gensler emphasized both the importance of protecting investors and having “clear rules of the road.” Despite this uncertainty, our contacts at the SEC indicate that the proposal is still in play and that they are still looking closely at the issue.

Conclusion

While the outcome of the proposal is uncertain, the fact that the SEC is looking closely at the “finder” issue is definitely a step in the right direction. The practical implications of the proposal are far-reaching as this is not an exercise with respect to some esoteric concept but, instead, it is an issue that companies, finders, and the legal community address on a constant basis.

As is generally the case, the SEC is attempting to determine whether this proposed construct not only enhances an issuer’s ability to raise capital but whether it also provides adequate shareholder protections. These are legitimate considerations the SEC must weigh, but the mere acknowledgment that this issue needs to be addressed is a positive. So, we will continue to keep a close eye on this very important proposal.

Alonzo Llorens and **Olivia Daly** are attorneys at **Parker Poe**. Alonzo is based in Atlanta, Georgia, and has substantial experience in corporate law and represents clients ranging from startups to Fortune 500 companies. His legal career started with the federal government, as he worked as an attorney in the U.S. Department of the Treasury's Honors Program and later with the U.S. Securities and Exchange Commission in its Division of Corporation Finance. Olivia is based in Greenville, South Carolina, where she practices primarily in the areas of mergers and acquisitions, general corporate law, corporate finance, and commercial lending.

They can be reached at and .

17 CFR § 240.15a-6 - Exemption of certain foreign brokers or dealers.

§ 240.15a-6 Exemption of certain foreign brokers or dealers.

(a) A foreign broker or dealer shall be exempt from the registration requirements of sections 15(a)(1) or 15B(a)(1) of the Act to the extent that the foreign broker or dealer:

(1) Effects transactions in securities with or for persons that have not been solicited by the foreign broker or dealer; or

(2) Furnishes research reports to major U.S. institutional investors, and effects transactions in the securities discussed in the research reports with or for those major U.S. institutional investors, provided that:

(i) The research reports do not recommend the use of the foreign broker or dealer to effect trades in any security;

(ii) The foreign broker or dealer does not initiate contact with those major U.S. institutional investors to follow up on the research reports, and does not otherwise induce or attempt to induce the purchase or sale of any security by those major U.S. institutional investors;

(iii) If the foreign broker or dealer has a relationship with a registered broker or dealer that satisfies the requirements of paragraph (a)(3) of this section, any transactions with the foreign broker or dealer in securities discussed in the research reports are effected only through that registered broker or dealer, pursuant to the provisions of paragraph (a)(3) of this section; and

(iv) The foreign broker or dealer does not provide research to U.S. persons pursuant to any express or implied understanding that those U.S. persons will direct commission income to the foreign broker or dealer; or

(3) Induces or attempts to induce the purchase or sale of any security by a U.S. institutional investor or a major U.S. institutional investor, provided that:

(i) The foreign broker or dealer:

(A) Effects any resulting transactions with or for the U.S. institutional investor or the major U.S. institutional investor through a registered broker or dealer in the manner described by paragraph (a)(3)(iii) of this section; and

(B) Provides the Commission (upon request or pursuant to agreements reached between any foreign securities authority, including any foreign government, as specified in section 3(a)(50) of the Act, and the Commission or the U.S. Government) with any information or documents within the possession, custody, or control of the foreign broker or dealer, any testimony of foreign associated persons, and any assistance in taking the evidence of other persons, wherever located, that the Commission requests and that relates to transactions under paragraph (a)(3) of this section, except that if, after the foreign broker or dealer has exercised its best efforts to provide the information, documents, testimony, or assistance, including requesting the appropriate governmental body and, if legally necessary, its customers (with respect to customer information) to permit the foreign broker or dealer to provide the information, documents, testimony, or assistance to the Commission, the foreign broker or dealer is prohibited from providing this information, documents, testimony, or assistance by applicable foreign law or regulations, then this paragraph (a)(3)(i)(B) shall not apply and the foreign broker or dealer will be subject to paragraph (c) of this section;

(ii) The foreign associated person of the foreign broker or dealer effecting transactions with the U.S. institutional investor or the major U.S. institutional investor:

(A) Conducts all securities activities from outside the U.S., except that the foreign associated persons may conduct visits to U.S. institutional investors and major U.S. institutional investors within the United States, provided that:

(1) The foreign associated person is accompanied on these visits by an associated person of a registered broker or dealer that accepts responsibility for the foreign associated person's communications with the U.S. institutional investor or the major U.S institutional investor; and

(2) Transactions in any securities discussed during the visit by the foreign associated person are effected only through the registered broker or dealer, pursuant to paragraph (a)(3) of this section; and

(B) Is determined by the registered broker or dealer to:

(1) Not be subject to a statutory disqualification specified in section 3(a)(39) of the Act, or any substantially equivalent foreign

(i) Expulsion or suspension from membership,

(ii) Bar or suspension from association,

(iii) Denial of trading privileges,

(iv) Order denying, suspending, or revoking registration or barring or suspending association, or

(v) Finding with respect to causing any such effective foreign suspension, expulsion, or order;

(2) Not to have been convicted of any foreign offense, enjoined from any foreign act, conduct, or practice, or found to have committed any foreign act substantially equivalent to any of those listed in sections 15(b)(4) (B), (C), (D), or (E) of the Act; and

(3) Not to have been found to have made or caused to be made any false foreign statement or omission substantially equivalent to any of those listed in section 3(a)(39)(E) of the Act; and

(iii) The registered broker or dealer through which the transaction with the U.S. institutional investor or the major U.S. institutional investor is effected:

(A) Is responsible for:

(1) Effecting the transactions conducted under paragraph (a)(3) of this section, other than negotiating their terms;

(2) Issuing all required confirmations and statements to the U.S. institutional investor or the major U.S. institutional investor;

(3) As between the foreign broker or dealer and the registered broker or dealer, extending or arranging for the extension of any credit to the U.S. institutional investor or the major U.S. institutional investor in connection with the transactions;

(4) Maintaining required books and records relating to the transactions, including those required by Rules 17a-3 and 17a-4 under the Act (17 CFR 2410.17a-3 and l7a-4);

(5) Complying with Rule 15c3-1 under the Act (17 CFR 240.15c3-1) with respect to the transactions; and

(6) Receiving, delivering, and safeguarding funds and securities in connection with the transactions on behalf of the U.S. institutional investor or the major U.S. institutional investor in compliance with Rule 15c3-3 under the Act (17 CFR 240.15c3-3);

(B) Participates through an associated person in all oral communications between the foreign associated person and the U.S. institutional investor, other than a major U.S. institutional investor;

(C) Has obtained from the foreign broker or dealer, with respect to each foreign associated person, the types of information specified in Rule l7a-3(a)(12) under the Act (17 CFR 240.17a-3(a)(12)), provided that the information required by paragraph (a)(12)(d) of that Rule shall include sanctions imposed by foreign securities authorities, exchanges, or associations, including without limitation those described in paragraph (a)(3)(ii)(B) of this section;

(D) Has obtained from the foreign broker or dealer and each foreign associated person written consent to service of process for any civil action brought by or proceeding before the Commission or a self-regulatory organization (as defined in section 3(a)(26) of the Act), providing that process may be served on them by service on the registered broker or dealer in the manner set forth on the registered broker's or dealer's current Form BD; and

(E) Maintains a written record of the information and consents required by paragraphs (a)(3)(iii) (C) and (D) of this section, and all records in connection with trading activities of the U.S. institutional investor or the major U.S. institutional investor involving the foreign broker or dealer conducted under paragraph (a)(3) of this section, in an office of the registered broker or dealer located in the United States (with respect to nonresident registered brokers or dealers, pursuant to Rule 17a-7(a) under the Act (17 CFR 240.17a-7(a))), and makes these records available to the Commission upon request; or

(4) Effects transactions in securities with or for, or induces or attempts to induce the purchase or sale of any security by:

(i) A registered broker or dealer, whether the registered broker or dealer is acting as principal for its own account or as agent for others, or a bank acting pursuant to an exception or exemption from the definition of "broker" or "dealer" in sections 3(a)(4)(B), 3(a)(4)(E), or 3(a)(5)(C) of the Act (15 U.S.C. 78c(a)(4)(B), 15 U.S.C. 78c(a)(4)(E), or 15 U.S.C. 78c(a)(5)(C)) or the rules thereunder;

(ii) The African Development Bank, the Asian Development Bank, the Inter-American Development Bank, the International Bank for Reconstruction and Development, the International Monetary Fund, the United Nations, and their agencies, affiliates, and pension funds;

(iii) A foreign person temporarily present in the United States, with whom the foreign broker or dealer had a bona fide, pre-existing relationship before the foreign person entered the United States;

(iv) Any agency or branch of a U.S. person permanently located outside the United States, provided that the transactions occur outside the United States; or

(v) U.S. citizens resident outside the United States, provided that the transactions occur outside the United States, and that the foreign broker or dealer does not direct its selling efforts toward identifiable groups of U.S. citizens resident abroad.

(b) When used in this rule,

(1) The term ***family of investment companies*** shall mean:

(i) Except for insurance company separate accounts, any two or more separately registered investment companies under the Investment Company Act of 1940 that share the same investment adviser or principal underwriter and hold themselves out to investors as related companies for purposes of investment and investor services; and

(ii) With respect to insurance company separate accounts, any two or more separately registered separate accounts under the Investment Company Act of 1940 that share the same investment adviser or principal underwriter and function under operational or accounting or control systems that are substantially similar.

(2) The term ***foreign associated person*** shall mean any natural person domiciled outside the United States who is an associated person, as defined in section 3(a)(18) of the Act, of the foreign broker or dealer, and who participates in the solicitation of a U.S. institutional investor or a major U.S. institutional investor under paragraph (a)(3) of this section.

(3) The term ***foreign broker or dealer*** shall mean any non-U.S. resident person (including any U.S. person engaged in business as a broker or dealer entirely outside the United States, except as otherwise permitted by this rule) that is not an office or branch of, or a natural person associated with, a registered broker or dealer, whose securities activities, if conducted in the United States, would be described by the definition of "broker" or "dealer" in sections 3(a)(4) or 3(a)(5) of the Act.

(4) The term ***major U.S. institutional investor*** shall mean a person that is:

(i) A U.S. institutional investor that has, or has under management, total assets in excess of $100 million; provided, however, that for purposes of determining the total assets of an investment company under this rule, the investment company may include the assets of any family of investment companies of which it is a part; or

(ii) An investment adviser registered with the Commission under section 203 of the Investment Advisers Act of 1940 that has total assets under management in excess of $100 million.

(5) The term ***registered broker or dealer*** shall mean a person that is registered with the Commission under sections 15(b), 15B(a)(2), or 15C(a)(2) of the Act.

(6) The term ***United States*** shall mean the United States of America, including the States and any territories and other areas subject to its jurisdiction.

(7) The term ***U.S. institutional investor*** shall mean a person that is:

(i) An investment company registered with the Commission under section 8 of the Investment Company Act of 1940; or

(ii) A bank, savings and loan association, insurance company, business development company, small business investment company, or employee benefit plan defined in Rule 501(a)(1) of Regulation D under the Securities Act of 1933 (17 CFR 230.501(a)(1)); a private business development company defined in Rule 501(a)(2) (17 CFR 230.501(a)(2)); an organization described in section 501(c)(3) of the Internal Revenue Code, as defined in Rule 501(a)(3) (17 CFR 230.501(a)(3)); or a trust defined in Rule 501(a)(7) (17 CFR 230.501(a)(7)).

(c) The Commission, by order after notice and opportunity for hearing, may withdraw the exemption provided in paragraph (a)(3) of this section with respect to the subsequent activities of a foreign broker or dealer or class of foreign brokers or dealers conducted from a foreign country, if the Commission finds that the laws or regulations of that foreign country have prohibited the foreign broker or dealer, or one of a class of foreign brokers or dealers, from providing, in response to a request from the Commission, information or documents within its possession, custody, or control, testimony of foreign associated persons, or assistance in taking the evidence of other persons, wherever located, related to activities exempted by paragraph (a)(3) of this section.

[54 FR 30031, July 18, 1989, as amended at 72 FR 56568, Oct. 3, 2007]

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Moreover, if the registered broker-dealer ignores indications of irregularity that should alert the registered broker-dealer to the likelihood that the foreign broker-dealer is taking advantage of U.S. customers or otherwise violating U.S. securities laws, and the registered broker-dealer nevertheless continues to effect questionable transactions on behalf of the foreign broker-dealer or its customers, the registered broker-dealer's role in the trades may give rise to possible violations of the federal securities laws.[153]

Finally, Rule 15a-6 as adopted does not allow banks to serve as the intermediary in transactions between U.S. institutional investors or major U.S. institutional investors and foreign broker-dealers. Despite the views expressed by several banks,[154] the Commission does not believe that it would be appropriate to permit any unregistered entity to perform this function, since this entity would not be subject to the Commission's extensive statutory authority to regulate, examine, and discipline registered broker-dealers.[155]

(2) Comments on U.S. institutional investor classifications. Proposed Rule 15a-6 would have allowed unregistered foreign broker-dealers to contact certain classes of U.S. institutional investors, which were limited to U.S. persons described in Rule 501(a) (1), (2), or (3) of Regulation D under the Securities Act[156] that, with the exception of registered broker-dealers, had total assets in excess of $100 million. These investors included domestic banks, savings and loan associations, brokers or dealers registered under section 15(b) of the Exchange Act,[157] insurance companies, registered investment companies, small business investment companies, employee benefit plans, private business development companies, and certain section 501(c)(3) organizations under the Internal Revenue Code.[158] Registered investment advisers were included as U.S. institutional investors within the rule if they had in excess of $100 million in assets under management. Further, if a registered investment company itself did not have total assets in excess of $100 million, it qualified as a U.S. institutional investor if it was part of a family of investment companies (as defined in the rule) that had total assets in excess of $100 million.

The expanded rule allowed direct contact with specified institutional investors, using the structure set out in the Chase Capital Markets U.S. letter.[159] Under the expanded rule, a foreign broker-dealer either could contact these institutional investors with the participation of an associated person supervised by a U.S. registered broker-dealer, or could contact major institutional investors directly. Similar conditions applied to both alternatives.

Six commenters opined that the definition of U.S. institutional investor should be expanded to include all accredited investors under Regulation D, regardless of assets.[160] In particular, the claim was made that persons qualifying as accredited investors under Regulation D, but with less than $100 million in assets, possessed adequate sophistication and judgment in financial matters to deal directly with foreign broker-dealers, consistent with their ability to make investment decisions without the disclosure afforded by the registration requirements of the Securities Act. It was averred that an asset test did not necessarily correlate with the degree of sophistication required to deal with unregistered foreign broker-dealers. Other commenters expressed a somewhat narrower view, asserting that the definition of U.S. institutional investor should be limited to institutional accredited investors.[161]

Alternatively, some commenters proposed other asset tests for major institutional investors, ranging from $1 million to 25 million in assets.[162] Another commenter suggested that, after a one-year trial period, the Commission consider broadening the definition of major U.S. institutional investor to include more institutions.[163] Finally, two commenters specifically said that the definition of U.S. institutional investor should include U.S. branches or agencies of foreign banks.[164]

As discussed in the Concept Release, the Commission recognizes that substantial institutional investors often have greater financial sophistication than individual investors. At the same time, the Commission does not believe that sophistication is in all circumstances an effective substitute for broker-dealer regulation. For example, systemic safeguards flowing from broker-dealer registration, such as financial responsibility requirements, are benefits that can be assured more effectively through governmental regulation.[165]

After considering the comments, the Commission has decided to retain the proposed rule's $100 million asset test for foreign broker-dealers contacting major U.S. institutional investors without an associated person of a registered broker-dealer participating in the contact.[166] As the Commission

[153] *Cf. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, Securities Exchange Act Release No. 19070 (Sept. 21, 1982), 26 SEC Docket 254 (continued execution of orders placed by investment adviser with discretion over account may subject broker-dealer to aiding and abetting liability, if broker-dealer has knowledge of improprieties in adviser's handling of account and adviser commits primary violation of securities laws).

[154] The Canadian Bankers Association, the Institute of International Bankers, and the Bank of America expressed the view that domestic banks should be permitted to serve as the U.S. intermediary for affiliated foreign broker-dealers. They claimed that, although U.S. banks are not registered with the Commission and thus, as pointed out by the ABA, are not subject to the Commission's regulatory, supervisory, or disciplinary authority, supervision by banking regulatory authorities would be an adequate substitute for Commission regulation.

[155] As explained below, however, the Commission has decided to include banks acting in broker or dealer capacity (including acting as municipal or government securities broker or dealer) in the category of persons with or for whom a foreign broker-dealer could effect, induce, or attempt to induce transactions and still qualify for an exemption from registration under the Rule.

[156] 17 CFR 230.501(a) (1), (2), or (3).

[157] 15 U.S.C. 78o(b).

[158] 26 U.S.C 501(c)(3).

[159] *Supra* note 130.

[160] CREF Continental Bank, the PSA, Westpac Banking Corporation, Chase Manhattan Government Securities, and Debevoise & Plimpton.

[161] The ABA, Sullivan & Cromwell, and Merrill Lynch. Continental Bank urged the Commission to adopt this approach if the Rule was not made applicable to all accredited investors.

[162] Security Pacific, the Institute of International Bankers, and the Toronto Stock Exchange.

[163] The NYSBA.

[164] The Institute of International Bankers and the NYSBA. In proposing Rule 15a-6, the Commission noted that accredited institutional investors under Regulation D included only domestic banks. Release 34-25801, 53 FR at 23654. *But see* note 168 *infra*.

[165] Similarly, in proposing Rule 144A, which would provide a safe-harbor exemption from the registration requirements of the Securities Act for resales of securities to institutional investors, the Commission sought to define a limited class of institutional investors that it could be "confident have extensive experience" in the market. Securities Act Release No. 6806 (Oct. 25, 1988), 53 FR 44016, 44028 ("Release 33-6806"). The Commission proposed to permit only a subset of institutions, those with over $100 million in assets, to resell securities free of resale restrictions. Release 33-6806, 53 FR at 44027-29. All comments received on proposed Rule 144A, together with a comment summary, are publicly available in File No. S7-23-88.

[166] Some commenters on proposed Rule 144A, *supra* note 165, suggested that the rule, if adopted, permit only those institutions with over $100 million in investment securities to resell securities free of resale restrictions. The staff is giving this suggestion serious consideration, in addition to considering other changes to the definition in Rule 144A of institutional investor including the scope of the term "family of investment companies that also appears in the Rule. If the Commission incorporates these changes into Rule 144A, then the Commission also will consider whether to incorporate similar standards into Rule 15a-6.

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

DIVISION OF
ET REGULATION

April 9, 1997

Giovanni P. Prezioso, Esq.
Cleary, Gottlieb, Steen & Hamilton
1752 N Street, N.W.
Washington, D.C. 20036-2806

Re: Securities Activities of U.S.-Affiliated Foreign Dealers

Dear Mr. Prezioso:

This letter responds to your letter dated March 24, 1997, on behalf of nine U.S. registered broker-dealers (the "Firms")[1] in which you request assurances that the staff will not recommend enforcement action to the Commission against any of the Firms or any foreign broker or dealer affiliated with any of the Firms (a "U.S.-Affiliated Foreign Dealer") if any of the U.S.-Affiliated Foreign Dealers engages in the securities activities described in your letter without registering as a "broker" or "dealer" under Section 15 of the Securities Exchange Act of 1934 ("Exchange Act") in reliance on the exemption from broker-dealer registration in Exchange Act Rule 15a-6.

As you note in your letter, in the years since the Commission adopted Rule 15a-6, internationalization of the securities markets has continued to accelerate. One result is that U.S. and foreign securities firms compete with one another to offer a wide range of financial products and services to their customers. In addition, institutional investors have taken a global approach in formulating their investment strategies. Moreover, the expanded use of

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[1] The Firms are Bear Stearns & Co. Inc.; Credit Suisse First Boston Corporation; CSFP Capital, Inc.; Goldman, Sachs & Co.; Lehman Brothers Inc.; Merrill Lynch, Pierce, Fenner & Smith, Incorporated; Morgan Stanley & Co. Incorporated; Salomon Brothers Inc; and Smith Barney Inc.

electronic communication technology has facilitated the dissemination of securities-related information and cross border trading activity, further developing the interrelationship between U.S. and foreign markets. You request relief from the staff on a number of specific aspects of Rule 15a-6 that you believe pose significant obstacles to the effective operation of international securities activities by U.S. broker-dealers and their foreign affiliates.[2]

I. Expanded Definition of "Major U.S. Institutional Investor"

Rule 15a-6, among other things, permits foreign broker-dealers to conduct certain securities activities with "U.S. institutional investors" and "major U.S. institutional investors," as those terms are defined in the Rule, provided that those foreign broker-dealers conduct those activities in conformity with the provisions of Rule 15a-6. These definitions do not include U.S. business corporations and partnerships, nor do they permit investment funds to qualify as major U.S. institutional investors if they are advised by investment managers that are exempt from registration under the Investment Advisers Act of 1940. It is your belief that these investors may have financial wherewithal comparable to that of institutional investors covered by the Rule, and that the Rule's failure to include these investors within the definitional criteria set forth in the Rule severely constrains the utility of the Rule 15a-6 exemption.

As a result, you request the staff to provide no-action relief that will permit U.S.-Affiliated Foreign Dealers to expand the range of U.S. investors with which they may enter into securities transactions in reliance on paragraph (a)(3) of Rule 15a-6. Specifically, you request that the staff grant no-action relief that will permit, on the same basis as permitted

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[2] You note that comparable issues arise in connection with the registration requirements for foreign government securities brokers or dealers under the Government Securities Act of 1986, codified at Section 15C of the Exchange Act. The Department of the Treasury, pursuant to its authority under Exchange Act Section 15C(a)(5), has adopted an exemptive rule that largely parallels Rule 15a-6. See 17 C.F.R. § 401.9. Accordingly, pursuant to 17 C.F.R. § 400.2(d), you request that any no-action or interpretive relief granted by the staff in response to this request with respect to the application of Section 15(a) of the Exchange Act and Rule 15a-6 also apply equally with respect to the entities that are subject to 17 C.F.R. § 401.9.

for transactions with "major U.S. institutional investors" under Rule 15a-6, a U.S.-Affiliated Foreign Dealer to enter into transactions with any entity, including any investment adviser (whether or not registered under the Investment Advisers Act), that owns or controls (or, in the case of an investment adviser, has under management) in excess of $100 million in aggregate financial assets (i.e., cash, money-market instruments, securities of unaffiliated issuers, futures and options on futures and other derivative instruments).[3]

II. Direct Transfer of Funds and Securities Between U.S. Investors and U.S.-Affiliated Foreign Dealers

You also request relief from a provision of Rule 15a-6(a)(3) that requires a U.S. registered broker-dealer to intermediate transactions between U.S.-Affiliated Foreign Dealers and U.S. institutional investors and major U.S. institutional investors. In particular, you note that paragraph (a)(3)(iii)(A)(6) of Rule 15a-6 requires that a U.S. broker-dealer intermediary be responsible for receiving, delivering, and safeguarding funds and securities in connection with transactions between U.S.-Affiliated Foreign Dealers and U.S. institutional investors and major U.S. institutional investors in compliance with Rule 15c3-3 under the Exchange Act. It is your contention that Rule 15a-6(a)(3)(iii)(A)(6) is unclear in circumstances where a U.S. investor and a foreign broker-dealer wish to settle a securities transaction intermediated by a U.S. broker-dealer involving the direct transfer of funds and securities. In particular, you note that questions have arisen regarding whether, under the Rule, the clearance and settlement of all such transfers must be effected through the accounts of the U.S. broker-dealer intermediating the transaction.

Interposition of a U.S. broker-dealer in the clearance and settlement process, you contend, causes a significant duplication of functions by the U.S. broker-dealer and foreign broker-dealer, including effecting duplicate transfers of funds and securities. You argue that

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3 You note that the asset test would be calculated on a gross basis, without deduction for liabilities of the institution, based on the balance sheet or comparable financial statement of the institution prepared in the ordinary course of its business. You also note that the requested relief in this context would apply to transactions in U.S. and foreign securities.

this duplication of functions is inefficient and increases the risk of operational errors and settlement failure. As a result, you ask the staff to confirm that in transactions involving foreign securities[4] or U.S. Government securities intermediated by a U.S. broker-dealer under Rule 15a-6, clearance and settlement may occur through the direct transfer of funds and securities between a U.S. investor and a foreign broker-dealer in situations where the foreign broker-dealer is not acting as custodian of the funds or securities of the U.S. investor. For such transactions in such securities the U.S. investor or its custodian could transfer funds or such securities directly to the foreign broker-dealer or its agent and the foreign broker-dealer or its agent could transfer any funds or such securities directly to the U.S. investor or its custodian. This requested relief would apply only in circumstances where (1) the foreign broker-dealer agrees to make available to the intermediating U.S. broker-dealer clearance and settlement information relating to such transfers and (2) the foreign broker-dealer is not in default to any counterparty on any material financial market transaction. Moreover, the requested relief would apply solely to the operational issue of the transfer of funds and securities between a foreign broker-dealer and a U.S. institutional investor or major U.S. institutional investor (including those investors with which a U.S.-Affiliated Foreign Dealer would be able to enter into transactions pursuant to the relief you request in Part II.A of your letter) in the context of clearance and settlement of transactions in foreign securities or U.S. Government securities between that foreign broker-dealer and that U.S. investor where the foreign broker-dealer is not acting as custodian for the U.S. investor.

You note that the granting of such relief should not be construed to suggest that the staff has made any implicit or explicit determinations regarding the permissibility of any particular transaction or custodial arrangement related to such a transfer. In this regard, you acknowledge that the foreign broker-dealer would continue to be required to ensure that each

[4] You use the term "foreign securities" as defined in your previous correspondence relating to Rule 15a-6. See Cleary, Gottlieb, Steen & Hamilton (November 22, 1995, revised January 30, 1996).

such transaction and any custodial arrangement qualifies in all other respects for exemption under the Rule, even though the direct transfer of funds and securities would be permitted to occur as described above. Finally, you note that the intermediating U.S. broker-dealer would fulfill all of the other enumerated duties under paragraph (a)(3)(iii)(A) of the Rule, including effecting the transactions, issuing required confirmations and maintaining required books and records relating to the transactions.

III. Permissible Contacts with U.S. Investors by Foreign Associated Persons of U.S.-Affiliated Foreign Dealers

You also request relief from the provisions of Rule 15a-6 that require an associated person of a U.S. broker-dealer intermediary to participate in certain communications between foreign associated persons of a foreign broker-dealer and certain U.S. investors. In particular, you note that paragraph (a)(3)(iii)(B) of Rule 15a-6 requires that an associated person of the U.S. broker-dealer intermediary participate in all oral communications between foreign associated persons and U.S. institutional investors other than major U.S. institutional investors, and that paragraph (a)(3)(ii)(A)(1) of Rule 15a-6 requires participation by an associated person of the U.S. broker-dealer intermediary in connection with visits in the United States by a foreign associated person with both U.S. institutional investors and major U.S. institutional investors.

1. Chaperoning Requirements

You argue that these "chaperoning" requirements have proven awkward to implement in practice, particularly in the context of those markets that are separated from the U.S. by a large number of time zones. You contend that they also provide only slight policy benefits in light of the experience and capabilities of the U.S. institutional investors eligible to enter into transactions under paragraph (a)(3) of Rule 15a-6 and the other investor protections provided by the Rule, such as the requirement that the foreign associated person not be subject to a statutory disqualification as defined in Section 3(a)(39) of the Exchange Act.

Accordingly, you request that the staff grant no-action relief that would permit foreign associated persons of a U.S.-Affiliated Foreign Dealer, without the participation of an associated person of an affiliated Firm,[5] to: (1) engage in oral communications from outside the United States with U.S. institutional investors where such communications take place outside of the trading hours of the New York Stock Exchange (i.e., at present, 9:30 a.m. to 4:00 p.m. New York Time), so long as the foreign associated persons do not accept orders to effect transactions other than those involving foreign securities (as defined in note 5 of your letter) and (2) have in-person contacts during visits to the United States with major U.S. institutional investors (including those investors with which a U.S.-Affiliated Foreign Dealer would be able to enter into transactions pursuant to the relief requested in Part II.A of your letter), so long as the number of days on which such in-person contacts occur does not exceed 30 per year and the foreign associated persons engaged in such in-person contacts do not accept orders to effect securities transactions while in the United States.[6]

2. Electronic Quotation Systems

In addition, you seek relief with respect to the U.S. distribution of foreign broker-dealers' quotations. In the release adopting Rule 15a-6, the Commission indicated that the Rule "generally would permit the U.S. distribution of foreign broker-dealers' quotations by third party systems...that distributed these quotations primarily in foreign countries" provided that the third-party systems did not allow securities transactions to be executed between the

[5] As you note, foreign associated persons of the U.S.-Affiliated Foreign Dealers could continue to have "unchaperoned" contacts with U.S. persons at any time if they are dually employed or "two-hatted" (i.e., also qualified as registered representatives acting on behalf of and under the supervision of an affiliated Firm under U.S. self-regulatory organization guidelines).

[6] As you request, the staff is clarifying that the limitations set forth in paragraph (a)(2)(ii) of Rule 15a-6 would not prohibit a foreign broker-dealer from initiating follow-up contacts with major U.S. institutional investors (including those entities qualifying pursuant to the relief you request in Part II.A of your letter) to which it has furnished research reports, if such follow-up contacts occur in the context of a relationship between a foreign broker-dealer and a U.S. intermediary broker-dealer under the Rule.

foreign broker-dealer and persons in the U.S. through the systems.[7] In other words, in the absence of other contacts with U.S. investors initiated by the third party systems, distribution of such quotes by such systems would not be considered to be a form of solicitation.[8] Because third-party quotation services have become increasingly global in scope since Rule 15a-6 was adopted, it is your view that the distinction between systems that distribute quotations primarily in the U.S. and those that distribute quotations primarily in foreign countries is no longer a useful regulatory dividing line. As a result, as you request, the staff is clarifying that the interpretive portions of the Adopting Release requiring operation of quotation systems by third parties that primarily distribute foreign broker-dealers' quotations (including prices and other trade-reporting information input directly by foreign broker-dealers) in foreign countries no longer apply.

With respect to proprietary quotation systems, you highlight a passage from the Adopting Release where the Commission noted that "the direct dissemination of a foreign market maker's quotations to U.S. investors, such as through a private quote system controlled by a foreign broker-dealer would not be appropriate without registration, because the dissemination of these quotations would be a direct, exclusive inducement to trade with that foreign broker-dealer." You note, however, that there is no express indication that the Commission's position in the Adopting Release is intended to preclude a foreign broker-dealer from directly inducing U.S. investors to trade with the foreign broker-dealer via a quotation system where the U.S. investor subscribes to the quotation system through a U.S. broker-dealer, the U.S. broker-dealer has continuing access to the quotation system, and the foreign broker-dealer's other contacts with U.S. investors are permissible under Rule 15a-6.

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[7] See Exchange Act Release No. 27017 (July 11, 1989), 54 FR 30,013 (July 18, 1989) ("Adopting Release").

[8] As the Commission stated in the Adopting Release, however, foreign broker-dealers whose quotes were distributed through such systems would not be allowed to initiate contacts with U.S. persons "beyond those exempted under the Rule, without registration or further exemptive rulemaking."

In this regard, as you request, the staff is confirming that providing U.S. investors with access to screen-based quotation systems that supply quotations, prices and other trade-reporting information input directly by foreign broker-dealers will not constitute an impermissible contact with a foreign broker-dealer, so long as any transactions between the U.S. investor and the foreign broker-dealer are intermediated in accordance with the requirements of Rule 15a-6. As you note, a foreign broker-dealer that directs quotations to U.S. investors through a proprietary system (as distinct from a third-party system) would be viewed as having "solicited" any resulting transactions (and thus could not rely on the exemption in paragraph (a)(1) of Rule 15a-6), although it would continue to be allowed to effect transactions in reliance on other available provisions of the Rule.

Response:

While not necessarily agreeing or disagreeing with the reasoning contained in your letter, based on the facts and representations presented, the staff of the Division of Market Regulation will not recommend enforcement action to the Commission under Section 15(a) of the Exchange Act against any of the Firms (or a similarly situated U.S. registered broker-dealer), any U.S.-Affiliated Foreign Dealer (or a similarly situated foreign broker-dealer) if any of the U.S.-Affiliated Foreign Dealers (or a similarly situated foreign broker-dealer) engages in the securities activities described in your letter without registering as a "broker" or "dealer" under Section 15 of the Exchange Act.[9]

This letter represents the views of the Division based on our understanding of the proposed activities of the U.S.-Affiliated Foreign Dealers as discussed in your letter. This staff position concerns enforcement action only and does not represent a legal conclusion regarding the applicability of the statutory or regulatory provisions of the federal securities laws. Moreover, this position is based solely on the representations that you have made, and

[9] Consultations with staff of the Department of the Treasury have affirmed that this relief applies equally with respect to those entities that are subject to 17 C.F.R. § 401.9. See note 2 above.

any different facts or conditions might require a different response.

Sincerely,

Richard R. Lindsey
Director

cc: Roger Anderson
Deputy Assistant Secretary for Federal Finance
Department of the Treasury

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Securities Exchange Act of 1934
Section 15(a); Rule 15a-6

March 24, 1997

Office of Chief Counsel

MAR 2 6 1997

Division of Market Regulati[illegible]

VIA HAND DELIVERY

Mr. Richard R. Lindsey
Director, Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Request for No-Action and Interpretive Relief Relating to Certain Securities Activities of U.S.-Affiliated Foreign Dealers

Dear Mr. Lindsey:

We are writing on behalf of our clients, listed in note 1 of this letter,[1] to request your advice that the staff would not recommend that the Securities and Exchange Commission (the "Commission") take any enforcement action against any of the Firms or any

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[1] Bear, Stearns & Co. Inc.; Credit Suisse First Boston Corporation; CSFP Capital, Inc.; Goldman, Sachs & Co.; Lehman Brothers Inc.; Merrill Lynch, Pierce, Fenner & Smith, Incorporated; Morgan Stanley & Co. Incorporated; Salomon Brothers Inc; and Smith Barney Inc. (hereinafter referred to as the "Firms").

foreign broker or dealer affiliated with any of the Firms (a "U.S.-Affiliated Foreign Dealer") in the event that a U.S.-Affiliated Foreign Dealer engages in the securities activities described in Parts II.A through II.C of this letter without registering as a "broker" or "dealer" under Section 15 of the Securities Exchange Act of 1934, as amended (the "Exchange Act").

I. Background

In light of the growing internationalization of financial markets, the Commission provided securities firms in the late 1980's with significant guidance -- first through a series of no-action letters[2] and then through the adoption of Rule 15a-6 -- regarding the circumstances in which a foreign broker-dealer may engage in securities activities with U.S. persons without having to register under Section 15 of the Exchange Act.[3] In the years since adoption of Rule 15a-6, the internationalization of the securities markets has continued to accelerate. U.S. and foreign securities firms increasingly compete directly with one another to offer a comprehensive and cost-effective range of financial products and related services to their customers. At the same time, institutional investors have broadly come to consider it essential to take a global approach in formulating their investment strategy. In addition, the widespread availability of computer-based and related communication technologies has led to greater dissemination of securities-related information and trading activity across borders, and has heightened the interrelationship between U.S. and foreign markets.

Several aspects of the current U.S. regulatory regime unnecessarily restrict and hamper the global competitiveness of U.S. broker-dealers by severely limiting their ability to provide U.S. investors with access to securities products and local market expertise offered by foreign broker-dealers. In particular, Rule 15a-6 imposes a number of restrictions on both (i) the categories of institutional investors with which foreign broker-dealers may have contacts and (ii) the specific regulatory and procedural functions that must be performed by a U.S.

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2 See, e.g., National Westminster Bank PLC (July 7, 1988); Security Pacific Corporation (April 1, 1988); Chase Capital Markets U.S. (July 28, 1987).

3 Comparable issues arise in connection with the registration requirements for foreign government securities brokers or dealers under the Government Securities Act of 1986, codified at Section 15C of the Exchange Act. In this regard, the Department of the Treasury, pursuant to its authority under Section 15C(a)(5), has adopted an exemptive rule that largely parallels Rule 15a-6. See 17 C.F.R. § 401.9. Accordingly, pursuant to 17 C.F.R. § 400.2(d), the Firms request that any no-action or interpretive relief granted by the staff in response to this request with respect to the application of Section 15(a) of the Exchange Act and Rule 15a-6 also apply equally with respect to the entities that are subject to 17 C.F.R. § 401.9.

broker-dealer intermediating transactions between foreign broker-dealers and U.S. institutional investors. These restrictions have, in light of experience with the Rule and the evolution of the financial markets, proven unduly burdensome in many respects -- frequently in circumstances where they do not appear to achieve any clear offsetting regulatory benefits.

Accordingly, as a policy matter, the Firms strongly encourage the Commission to evaluate broad reforms to the U.S. regulatory regime that would enhance the competitiveness of U.S. securities firms and eliminate practical barriers to participation by their foreign affiliates in U.S. markets, while maintaining high standards of investor protection and market integrity in the United States and abroad. Moreover, a number of specific aspects of Rule 15a-6 pose significant obstacles to the effective conduct of international securities activities by U.S. broker-dealers and their foreign affiliates. In the Firms' view, the elimination of these obstacles requires especially prompt attention from the Commission that should not wait for the adoption of needed broader reforms. The Firms have therefore sought to identify, in Parts II.A through II.C below, those areas in which prompt interpretive or no-action relief from the staff would provide substantial benefits without compromising investor protection.

II. Proposed Relief

A. Expanded Definition of "Major U.S. Institutional Investor" in Rule 15a-6

Currently, the definitions of "major U.S. institutional investor" and "U.S. institutional investor" set forth in paragraphs (b)(4) and (b)(7) of Rule 15a-6, respectively, exclude a number of important categories of large and experienced institutional investors, thereby preventing foreign broker-dealers from effecting transactions with such investors in reliance on the exemption provided by paragraph (a)(3) of the Rule. Because direct contacts by a foreign broker-dealer with U.S. investors are permitted only if the investors meet these definitional criteria, the limitations under the current rule on eligible counterparties severely constrain the utility of that exemption.

At present, even the largest U.S. business corporations and partnerships do not qualify under the definitions of "U.S. institutional investor" and "major U.S. institutional investor." These business enterprises have a strong interest in obtaining direct access to foreign broker-dealers and form an important component of the investor base for which U.S. broker-dealers and their affiliates compete internationally. Moreover, these investors have the financial wherewithal and experience necessary to evaluate the potential rewards and risks of entering into transactions involving foreign broker-dealers.

In addition, a number of the most important institutional participants in the world financial markets are organized as investment funds advised by investment managers exempt from registration under the Investment Advisers Act of 1940 (the "Investment Advisers Act") (typically because of the small number of clients that they advise). Because paragraph (b)(4) of Rule 15a-6 is never available for an unregistered adviser, the funds and other clients advised by these managers currently cannot qualify as "major U.S. institutional investors," despite their extensive experience in international markets and their substantial assets.

Accordingly, the Firms request that the Commission provide no-action relief that would expand the range of U.S. investors with which U.S.-Affiliated Foreign Dealers may enter into securities transactions in reliance on paragraph (a)(3) of Rule 15a-6. Specifically, the Firms request that the staff grant no-action relief that would permit, on the same basis as permitted for transactions with "major U.S. institutional investors" under Rule 15a-6, a U.S.-Affiliated Foreign Dealer to enter into transactions with any entity, including any investment adviser (whether or not registered under the Investment Advisers Act), that owns or controls (or, in the case of an investment adviser, has under management) in excess of $100 million in aggregate financial assets (i.e., cash, money-market instruments, securities of unaffiliated issuers, futures, options on futures and other derivative instruments).[4]

The requested relief would substantially enhance the utility of the paragraph (a)(3) exemption by extending its availability to transactions with important additional categories of investors whose experience and capabilities as to investment matters are comparable to those of "major U.S. institutional investors" that currently qualify under the Rule. In the Firms' view, no policy objective appears to be served by continuing to exclude such investors from the range of counterparties with which a U.S.-Affiliated Foreign Dealer may engage in transactions under the paragraph (a)(3) exemption, especially in light of the participation of a U.S. broker-dealer intermediary and the other protections afforded in transactions effected in reliance on that exemption.

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4 We understand that the asset test would be calculated on a gross basis, without deduction for liabilities of the institution, based on the balance sheet or comparable financial statement of the institution prepared in the ordinary course of its business. We also understand that the requested relief would apply to transactions in U.S. and foreign securities.

B. Direct Transfer of Funds and Securities Between U.S. Investors and U.S.-Affiliated Foreign Dealers

Rule 15a-6(a)(3) explicitly requires that a U.S. registered broker-dealer intermediating transactions between U.S. investors and a foreign broker-dealer assume responsibility for certain regulatory requirements. Specifically, paragraph (a)(3)(iii)(A)(6) of Rule 15a-6 requires that a U.S. broker-dealer intermediary be responsible for "receiving, delivering, and safeguarding funds and securities in connection with the transactions on behalf of the U.S. institutional investor or the major U.S. institutional investor in compliance with Rule 15c3-3" under the Exchange Act.

The application of paragraph (a)(3)(iii)(A)(6) is not entirely clear in circumstances where a U.S. investor and a foreign broker-dealer wish to settle a securities transaction intermediated by a U.S. broker-dealer involving the direct transfer of funds and securities. In particular, questions have arisen regarding whether, under the Rule, the clearance and settlement of all such transfers must be effected through the accounts of the U.S. broker-dealer intermediating the transaction.

In the Firms' view, a U.S. broker-dealer should not be required to interpose itself in the mechanical process of settling securities transactions effected pursuant to paragraph (a)(3). Interposition of a U.S. broker-dealer in the clearance and settlement process causes a significant duplication of functions by the U.S. and foreign broker-dealer (e.g., maintaining duplicate custody arrangements and bank accounts, and effecting duplicate transfers of funds and securities). This duplication of functions not only is inefficient from a cost perspective, but also increases the risk of operational errors and settlement failure (since twice the number of bookkeeping entries and transfers must occur). Moreover, entities qualifying as "U.S. institutional investors" and "major U.S. institutional investors" frequently elect (and may, in some cases, be required by law) to engage foreign custodians directly to hold, receive and deliver their foreign securities and local currency (including in circumstances where a foreign jurisdiction prohibits U.S. broker-dealers from holding securities or currency for customers). In this context, the current rule appears to provide little benefit to U.S. institutional investors and imposes a significant barrier to efficient settlement of international transactions.

Thus, the Firms request that the staff provide guidance confirming that, in transactions involving foreign securities[5] or U.S. Government securities intermediated by a

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5 For purposes of this request, we use the term "foreign securities" as defined in our previous correspondence relating to Rule 15a-6. See Cleary, Gottlieb, Steen & Hamilton (November 22, 1995, revised January 30, 1996).

U.S. broker-dealer under Rule 15a-6, clearance and settlement may occur through the direct transfer of funds and securities between the U.S. investor and the foreign broker-dealer in situations where the foreign broker-dealer is not acting as custodian of the funds or securities of the U.S. investor.[6] This guidance would confirm that for such transactions in such situations the U.S. investor or its custodian could transfer funds or such securities directly to the foreign broker-dealer or its agent and the foreign broker-dealer or its agent could transfer any funds or such securities directly to the U.S. investor or its custodian. We understand that this guidance would be applicable only in circumstances where (i) the foreign broker-dealer agrees to make available to the intermediating U.S. broker-dealer clearance and settlement information relating to such transfers and (ii) the foreign broker-dealer is not in default on any material financial market transactions.

This interpretive relief would enhance the ability of U.S. investors to enter into securities transactions with foreign broker-dealers without detracting significantly from the Commission's investor protection mandate under the Exchange Act. Although certain mechanical aspects of clearing and settling transactions would not be performed by the U.S. broker-dealer intermediary, U.S. investors would continue to benefit from the other protections provided by Rule 15a-6. In particular, the U.S. broker-dealer would fulfill all of the other enumerated duties under paragraph (a)(3)(iii)(A), including effecting the transactions, issuing required confirmations and maintaining required books and records relating to the transactions.[7]

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6 In general, the difficulties described above relate primarily to transactions in foreign securities and U.S. Government securities and thus the Firms do not, at present, request that the staff address the issues that would be posed more generally by transactions involving U.S. securities, although it may be appropriate to do so in the context of anticipated rulemaking in this area.

7 The inability of a foreign broker-dealer to receive and safeguard securities for customers in transactions effected under Rule 15a-6 presents a hindrance to the effective provision of cross-border securities services to U.S. investors. The laws of several foreign jurisdictions effectively prohibit a U.S. broker-dealer from clearing and settling transactions for its customers in those jurisdictions. In light of the obstacles that local legal, tax and similar restrictions may pose to the ability of a U.S. broker-dealer to provide safekeeping services to U.S. customers investing in a foreign country, we understand that the Commission staff has been and would continue to be willing to provide individual firms with prompt assistance addressing these concerns on a case-by-case basis through the no-action process. See Morgan Stanley India Securities Pvt. Ld. (December 20, 1996).

The requested relief would apply solely to the operational issue of the transfer of funds and securities between a foreign broker-dealer and a U.S. institutional investor or a major U.S. institutional investor (including an entity qualifying pursuant to the relief requested in Part II.A of this letter) in the context of clearance and settlement of transactions in foreign securities or U.S. Government securities between that foreign broker-dealer and that U.S. investor where the foreign broker-dealer is not acting as custodian for the U.S. investor. We understand that the granting of such relief should not be construed to suggest that the staff has made any implicit or explicit determination regarding the permissibility of any particular transaction or custodial arrangement related to such a transfer. In other words, the foreign broker-dealer would continue to be required to ensure that each such transaction and any custodial arrangement qualifies in all other respects for exemption under the Rule, even though the direct transfer of funds and securities would be permitted to occur as described above.

C. Permissible Contacts with U.S. Investors by Foreign Associated Persons of U.S.-Affiliated Foreign Dealers

Paragraph (a)(3) of Rule 15a-6 requires that an associated person of a U.S. broker-dealer intermediary participate in certain communications between foreign associated persons of a foreign broker-dealer and U.S. investors. Specifically, paragraph (a)(3)(iii)(B) requires that an associated person of the U.S. broker-dealer intermediary participate in any oral communications between foreign associated persons and U.S. institutional investors that are not "major U.S. institutional investors," and paragraph (a)(3)(ii)(A)(1) requires participation by an associated person of the U.S. broker-dealer intermediary in connection with visits in the United States by a foreign associated person with both U.S. institutional investors and major U.S. institutional investors.

1. Chaperoning Requirements

The "chaperoning" requirements prescribed by paragraph (a)(3) of Rule 15a-6 have proven awkward to implement in practice, particularly in the context of Asian markets separated from the United States by a large number of time zones. Moreover, "chaperoning" provides only slight policy benefits given the experience and capabilities of the U.S. institutional investors eligible to enter into transactions under paragraph (a)(3) and the other investor protections provided under that exemption, including in particular the requirement that any foreign associated person not be subject to a "statutory disqualification" as defined in Section 3(a)(39) of the Exchange Act. In addition, the apparent absence of significant abuses in the context of major U.S. institutional investors (for whom "chaperoning" of oral communications generally is not required) since the adoption of Rule 15a-6 further confirms the appropriateness of limiting the scope of the chaperoning requirement for all U.S. institutional investors eligible to have direct contacts with foreign broker-dealers under the Rule.

Accordingly, the Firms request that the staff grant no-action relief that would permit foreign associated persons of a U.S.-Affiliated Foreign Dealer, without the participation of an associated person of an affiliated Firm,[8] to (i) engage in oral communications from outside the United States with U.S. institutional investors where such communications take place outside of the trading hours of the New York Stock Exchange (i.e., at present, 9:30 a.m. to 4:00 p.m. New York Time), so long as the foreign associated persons do not accept orders to effect transactions other than those involving foreign securities (as defined in note 5 above) and, (ii) have in-person contacts during visits to the United States with major U.S. institutional investors (including those investors with which a U.S.-Affiliated Foreign Dealer would be able to enter into transactions pursuant to the relief requested in Part II.A of this letter), so long as the number of days on which such in-person contacts occur does not exceed 30 per year and the foreign associated persons engaged in such in-person contacts do not accept orders while in the United States to effect securities transactions.[9]

2. Electronic Quotation Systems

In the adopting release for Rule 15a-6,[10] the Commission directed a number of comments to the application of the broker-dealer registration requirement to foreign broker-dealers whose quotations are distributed to investors through electronic systems. Specifically, the Adopting Release sets forth the interpretive position that Rule 15a-6 "generally would permit the U.S. distribution of foreign broker-dealers' quotations by third party systems . . . that distributed these quotations primarily in foreign countries," but indicated that this position

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8 We understand that foreign associated persons of the U.S.-Affiliated Foreign Dealers would continue to be able to have "unchaperoned" contacts with U.S. persons at any time if they are "two-hatted" (i.e., also qualified as registered representatives acting on behalf of and under the supervision of an affiliated Firm under U.S. self-regulatory organization guidelines).

9 In addition to the specific relief relating to "chaperoned" contacts described above, the Firms request clarification from the staff that the limitations set forth in paragraph (a)(2)(ii) of Rule 15a-6 would not prohibit a foreign broker-dealer from initiating follow-up contacts with major U.S. institutional investors (including those entities qualifying pursuant to the relief requested in Part II.A of this letter) to which it has furnished research reports, if such follow-up contacts occur in the context of a relationship between a foreign broker-dealer and a U.S. intermediary broker-dealer under the Rule.

10 Release No. 27017 (July 11, 1989), 54 Fed. Reg. 30,013 (July 18, 1989) (the "Adopting Release").

would be available "only to third-party systems that did not allow securities transactions to be executed between the foreign broker-dealer and persons in the U.S. through the systems."[11] In the Firms' view, because third-party quotation services have become increasingly global in scope since the time of the adoption of Rule 15a-6, this distinction between systems that distribute quotations primarily in the U.S. and systems that distribute quotations "primarily in foreign countries" can no longer, in practice, serve as a useful dividing line for achieving the Commission's regulatory objectives.

With respect to proprietary quotation systems, the Adopting Release noted that "direct dissemination of a foreign market maker's quotations to U.S. investors, such as through a private quote system controlled by a foreign broker-dealer" would not be appropriate because the dissemination of such quotations would constitute a direct inducement to trade with that foreign broker-dealer.[12] There is no express indication, however, that the Commission's position in the Adopting Release is intended to preclude a foreign broker-dealer from directly "inducing" U.S. investors to trade with the foreign broker-dealer via a quotation system where the U.S. investor subscribes to the quotation system through a U.S. broker-dealer, the U.S. broker-dealer has continuing access to the quotation system, and the foreign broker-dealer's other contacts with U.S. investors are permissible under Rule 15a-6.

Where a U.S. institutional investor effects transactions through a U.S. broker-dealer intermediary, no customer protection or other policy objective would seem to be served by denying the institutional investor direct electronic access to the quotations of a foreign broker-dealer -- especially since Rule 15a-6 currently provides clear authority for the quotations to be conveyed orally (if inconveniently) through a registered representative associated with the U.S. broker-dealer. In the Firms' view, the availability of improved technologies for providing investors with quotations should not be restricted merely because it is impossible to "chaperone" a data transmission.

Accordingly, the Firms request the staff's advice clarifying that, in light of this technological evolution, the interpretive portions of the Adopting Release requiring operation of quotation systems by third parties that primarily distribute quotations in foreign countries no

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11 The Commission stated, however, that foreign broker-dealers whose quotes were distributed through such systems would not be allowed to initiate contacts with U.S. persons "beyond those exempted under [Rule 15a-6], without registration or further exemptive rulemaking." Adopting Release, 54 Fed. Reg. at 30,018.

12 Adopting Release, 54 Fed. Reg. at 30,019.

longer apply.[13] In this connection, the Firms specifically request confirmation by the staff that providing U.S. investors with access to proprietary and third-party screen-based quotation systems that supply quotations, prices and other trade-reporting information input directly by foreign broker-dealers will not constitute an impermissible "contact" with a foreign broker-dealer, so long as any transactions between the U.S. investor and the foreign broker-dealer are intermediated in accordance with the requirements of Rule 15a-6.[14] In addition, we understand that the staff would be willing to provide individual firms with prompt additional guidance regarding the execution of such intermediated transactions through an automated trading system operated by the registered U.S. broker-dealer intermediary.

III. Conclusion

Based on the foregoing, we request your advice that the staff would not recommend that the Commission take any enforcement action against any of the Firms or any U.S.-Affiliated Foreign Dealer in the event that a U.S.-Affiliated Foreign Dealer engages in the securities activities described in Parts II.A through II.C above without registering as a "broker" or "dealer" under Section 15 of the Exchange Act.

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13 In addition to providing the specific clarification requested herein with regard to screen-based information systems, the Firms additionally encourage the Commission to continue its more general evaluation of issues under the Exchange Act and other federal securities laws relating to the impact of emerging technologies on the U.S. regulatory regime, including issues relating to electronic trading systems.

14 We recognize in this connection, however, that a foreign broker-dealer that directs quotations to U.S. investors through a proprietary system (as distinct from a third-party system) would be viewed as having "solicited" any resulting transactions (and thus could not rely on the exemption in paragraph (a)(1) of Rule 15a-6), although it would continue to be allowed to effect transactions in reliance on other available provisions of the Rule.

We would appreciate consideration of these matters as promptly as practicable. If for any reason the staff is not disposed to grant the requested no-action relief, we would also appreciate an opportunity to discuss the situation with the staff prior to the issuance of any formal letters. Questions regarding this no-action request should be directed to the undersigned (at 202-728-2758).

Sincerely yours,

Giovanni P. Prezioso

cc: Mr. Robert L.D. Colby
Deputy Director
Division of Market Regulation

Ms. Catherine McGuire
Chief Counsel
Division of Market Regulation

17 CFR § 240.3a4-1 - Associated persons of an issuer deemed not to be brokers.

§ 240.3a4-1 Associated persons of an issuer deemed not to be brokers.

(a) An associated person of an issuer of securities shall not be deemed to be a broker solely by reason of his participation in the sale of the securities of such issuer if the associated person:

(1) Is not subject to a statutory disqualification, as that term is defined in section 3(a)(39) of the Act, at the time of his participation; and

(2) Is not compensated in connection with his participation by the payment of commissions or other remuneration based either directly or indirectly on transactions in securities; and

(3) Is not at the time of his participation an associated person of a broker or dealer; and

(4) Meets the conditions of any one of paragraph (a)(4) (i), (ii), or (iii) of this section.

(i) The associated person restricts his participation to transactions involving offers and sales of securities:

(A) To a registered broker or dealer; a registered investment company (or registered separate account); an insurance company; a bank; a savings and loan association; a trust company or similar institution supervised by a state or federal banking authority; or a trust for which a bank, a savings and loan association, a trust company, or a registered investment adviser either is the trustee or is authorized in writing to make investment decisions; or

(B) That are exempted by reason of section 3(a)(7), 3(a)(9) or 3(a)(10) of the Securities Act of 1933 from the registration provisions of that Act; or

(C) That are made pursuant to a plan or agreement submitted for the vote or consent of the security holders who will receive securities of the issuer in connection with a reclassification of securities of the issuer, a merger or consolidation or a similar plan of acquisition involving an exchange of securities, or a transfer of assets of any other person to the issuer in exchange for securities of the issuer; or

(D) That are made pursuant to a bonus, profit-sharing, pension, retirement, thrift, savings, incentive, stock purchase, stock ownership, stock appreciation, stock option, dividend reinvestment or similar plan for employees of an issuer or a subsidiary of the issuer;

(ii) The associated person meets all of the following conditions:

(A) The associated person primarily performs, or is intended primarily to perform at the end of the offering, substantial duties for or on behalf of the issuer otherwise than in connection with transactions in securities; and

(B) The associated person was not a broker or dealer, or an associated person of a broker or dealer, within the preceding 12 months; and

(C) The associated person does not participate in selling an offering of securities for any issuer more than once every 12 months other than in reliance on paragraph (a)(4)(i) or (iii) of this section, except that for securities issued pursuant to rule 415 under the Securities Act of 1933, the 12 months shall begin with the last sale of any security included within one rule 415 registration.

(iii) The associated person restricts his participation to any one or more of the following activities:

(A) Preparing any written communication or delivering such communication through the mails or other means that does not involve oral solicitation by the associated person of a potential purchaser; *Provided, however,* that the content of such communication is approved by a partner, officer or director of the issuer;

(B) Responding to inquiries of a potential purchaser in a communication initiated by the potential purchaser; ***Provided, however,*** That the content of such responses are limited to information contained in a registration statement filed under the Securities Act of 1933 or other offering document; or

(C) Performing ministerial and clerical work involved in effecting any transaction.

(b) No presumption shall arise that an associated person of an issuer has violated section 15(a) of the Act solely by reason of his participation in the sale of securities of the issuer if he does not meet the conditions specified in paragraph (a) of this section.

(c) ***Definitions.*** When used in this section:

(1) The term ***associated person of an issuer*** means any natural person who is a partner, officer, director, or employee of:

(i) The issuer;

(ii) A corporate general partner of a limited partnership that is the issuer;

(iii) A company or partnership that controls, is controlled by, or is under common control with, the issuer; or

(iv) An investment adviser registered under the Investment Advisers Act of 1940 to an investment company registered under the Investment Company Act of 1940 which is the issuer.

(2) The term ***associated person of a broker or dealer*** means any partner, officer, director, or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with such broker or dealer, or any employee of such broker or dealer, except that any person associated with a broker or dealer whose functions are solely clerical or ministerial and any person who is required under the laws of any State to register as a broker or dealer in that State solely because such person is an issuer of securities or associated person of an issuer of securities shall not be included in the meaning of such term for purposes of this section.

[50 FR 27946, July 9, 1985]

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PRIVACY

Regulation of Investment Advisers

by the

U.S. Securities and Exchange Commission

March 2013

Staff of the Investment Adviser Regulation Office
Division of Investment Management
U.S. Securities and Exchange Commission

Regulation of Investment Advisers by the U.S. Securities and Exchange Commission[*]

I. Introduction

Money managers, investment consultants, and financial planners are regulated in the United States as "investment advisers" under the U.S. Investment Advisers Act of 1940 ("Advisers Act" or "Act") or similar state statutes. This outline describes the regulation of investment advisers by the U.S. Securities and Exchange Commission ("SEC").

The Advisers Act is the last in a series of federal statutes intended to eliminate abuses in the securities industry that Congress believed contributed to the stock market crash of 1929 and the depression of the 1930s. The Act is based on a congressionally-mandated study of investment companies, including consideration of investment counsel and investment advisory services, carried out by the SEC during the 1930s.[1] The SEC's report traced the history and growth of investment advisers and reflected the position that investment advisers could not properly perform their function unless all conflicts of interest between them and their clients were removed. The report stressed that a significant problem in the industry was the existence, either consciously or, more likely, unconsciously, of a prejudice by advisers in favor of their own financial interests.

The SEC's report culminated in the introduction of a bill that, with some changes, became the Advisers Act. The Act, as adopted, reflects congressional recognition of the delicate fiduciary nature of the advisory relationship, as well as Congress' desire to eliminate, or at least expose, all conflicts of interest that might cause advisers, either consciously or unconsciously, to render advice that is not disinterested.[2]

The outline that follows is divided into five sections, each of which addresses a different question: Who is an "investment adviser?" Which investment advisers must register with the SEC? Who must register under the Act? How does an investment adviser register under the Act? What are the requirements applicable to an investment adviser registered under the Act?

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[*] The U.S. Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. The views expressed in this outline are those of the staff of the Investment Adviser Regulation Office, and do not necessarily reflect the views of the U.S. Securities and Exchange Commission or others on the staff of the U.S. Securities and Exchange Commission. The Investment Adviser Regulation Office would like to thank Robert E. Plaze, the original author of this outline, for his substantial contribution.

[1] *See Investment Trusts and Investment Companies, Report of the Securities and Exchange Commission, Pursuant to Section 30 of the Public Utility Holding Company Act of 1935, on Investment Counsel, Investment Management, Investment Supervisory and Investment Advisory Services*, H.R. Doc. No. 477, 76th Cong., 2d Sess. (1939).

[2] *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 189, 191-192 (1963).

II. Who is an Investment Adviser?

A. Definition of Investment Adviser

Section 202(a)(11) of the Act defines an investment adviser as any person or firm that:

- for compensation;
- is engaged in the business of;
- providing advice to others or issuing reports or analyses regarding securities.

A person must satisfy all three elements to fall within the definition of "investment adviser," which the SEC staff has addressed in an extensive interpretive release explaining how the Act applies to financial planners, pension consultants and other persons who, as a part of some other financially related services, provide investment advice.[3] Published in 1987, Investment Advisers Act Release No. 1092 represents the views of the Division of Investment Management, which is primarily responsible for administering the Act.

1. *Compensation.* The term "compensation" has been broadly construed. Generally, the receipt of any economic benefit, whether in the form of an advisory fee, some other fee relating to the total services rendered, a commission, or some combination, satisfies this element.[4] The person receiving the advice or another person may pay the compensation.

2. *Engaged in the Business.* A person must be engaged in the business of providing advice. This does not have to be the sole or even the primary activity of the person. Factors used to evaluate whether a person is engaged are: (i) whether the person holds himself out as an investment adviser; (ii) whether the person receives compensation that represents a clearly definable charge for providing investment advice; and (iii) the frequency and specificity of the investment advice provided.[5] Generally, a person providing advice about specific securities will be "engaged in the business" unless specific advice is rendered only on a rare or isolated occasion.[6]

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3 *Applicability of the Investment Advisers Act of 1940 to Financial Planners, Pension Consultants, and Other Persons Who Provide Others with Investment Advice as a Component of Other Financial Services*, Investment Advisers Act Release No. 1092 (Oct. 8, 1987) ("Release 1092").

4 *Id.*; *see also Kenisa Oil Company,* SEC Staff No-Action Letter (May 6, 1982); *SEC v. Fife,* 311 F. 3d 1 (1st Cir. 2002) (a person provides advice "for compensation" if it understands that successful investment will yield it a commission); *In the Matter of Alexander V. Stein*, Investment Advisers Act Release. No. 1497 (June 8, 1995) (a person receives "compensation" if it fraudulently converts client funds to its own use).

5 *Zinn v. Parish,* 644 F.2d 360 (7th Cir. 1981); Release 1092, *supra* note 3.

6 For instance, the SEC staff would not view an employer providing advice to an employee in connection with an employer-sponsored employee benefit program to be in the business of providing advice, *see Letter to Olena Berg, Assistant Secretary, Department of Labor, from Jack W. Murphy, Chief Counsel, Division of Investment Management, SEC* (Feb. 22, 1996). *See also Zinn*, *supra* note 5 at 364 ("isolated transactions with a client as an incident to the main purpose of his management contract to negotiate football contracts do not constitute engaging in the business of advising others on investment securities.").

3. *Advising Others about Securities*

a. *Advice about Securities*. A person clearly meets the third element of the statutory test if he provides advice to others about specific securities, such as stocks, bonds, mutual funds, limited partnerships, and commodity pools. The SEC staff has stated that advice about real estate, coins, precious metals, or commodities is not advice about securities.[7] The more difficult questions arise with less specific advice, or advice that is only indirectly about securities. The SEC staff has stated in this regard:

(i) advice about market trends is advice about securities;[8]

(ii) advice about the selection and retention of other advisers is advice about securities;[9]

(iii) advice about the advantages of investing in securities versus other types of investments (*e.g.*, coins or real estate) is advice about securities;[10]

(iv) providing a selective list of securities is advice about securities even if no advice is provided as to any one security;[11] and

(v) asset allocation advice is advice about securities.[12]

b. *Advising Others.* Questions about whether a person advises "others" usually arise when a client is not a natural person. The SEC staff generally looks to the substance of the arrangement rather than its form:

(i) A general partner of a limited partnership that provides advice with respect to the investments of partnership assets is advising others (the limited partners) even where the general partner may have legal title to these assets.[13]

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7 *Robert R. Champion*, SEC Staff No-Action Letter (Sept. 22, 1986).

8 *Dow Theory Forecasts*, SEC Staff No-Action Letter (Feb. 2, 1978). Thus, market-timing advice is advice about securities. *See Maratta Advisory, Inc*., SEC Staff No-Action Letter (July 16, 1981).

9 Release 1092, *supra* note 3; *FPC Securities Corp*., SEC Staff No-Action Letter (Dec. 1, 1974). *See also SEC v. Bolla,* 401 F.Supp. 43 (D.D.C. 2005), *aff'd. in relevant part, SEC v. Washington Investment Network*, 475 F.3d 392 (D.C. Cir. 2007) (person selecting investment advisers for clients meets the Advisers Act's definition of "investment adviser").

10 Release 1092, *supra* note 3.

11 *RDM Infodustries, Inc.,* SEC Staff No-Action Letter (Mar. 25, 1996). The SEC staff takes the position that providing information about securities in a report does not constitute providing advice about the securities if: (i) the information is readily available to the public in its raw state; (ii) the categories of information presented are not highly selective; and (iii) the information is not organized or presented in a manner that suggests the purchase, holding, or sale of any security. *See id.*

12 *Maratta Advisory, Inc*., *supra,* note 8. *See also SEC v. Bolla, supra,* note 9.

13 *Abrahamson v. Fleschner*, 566 F.2d 862, 870 (2d Cir. 1977), *cert. denied*, 436 U.S. 913 (1978); *SEC v. Haligiannis*, 470 F. Supp. 2d 373, 383 (S.D.N.Y. 2007).

(ii) A wholly-owned corporate subsidiary exclusively advising the parent or another wholly owned corporate subsidiary would not generally be considered advising "others."[14]

c. *Investment Banking.* The SEC staff does not believe that the Act applies to persons whose activities are limited to advising issuers concerning the structuring of their securities offerings (although such advice may technically be about securities).[15]

d. *Non-U.S. Clients*. The Act is silent regarding whether the clients must be U.S. persons. The SEC takes the position that a U.S. person providing advice exclusively to non-U.S. persons would still be subject to the Act.[16]

B. <u>Exclusions from Definition</u>

There are several exclusions from the investment adviser definition available to persons who presumably (or at least arguably) satisfy all three elements of the definition. A person eligible for one of the exclusions is not subject to any provisions of the Act.

1. *Banks and Bank Holding Companies*. This exclusion is generally limited to U.S. banks and bank holding companies.[17] The SEC staff has stated that the exclusion is unavailable to non-U.S. banks,[18] credit unions, and investment adviser subsidiaries of banks or bank holding companies.[19]

2. *Lawyers, Accountants, Engineers, and Teachers*. The professional exclusion is available only to those professionals listed, and only if the advice given is incidental to the practice of their profession. Factors considered by staff to evaluate whether advice is incidental to a profession are: (i) whether the professional holds himself out as an investment adviser; (ii) whether the advice is reasonably related to the professional services provided; and (iii) whether the charge for advisory services is based on the same factors that

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14 *See Zenkyoren Asset Management of America Inc*., SEC Staff No-Action Letter (June 30, 2011).

15 *See, e.g., The Applicability of the Investment Advisers Act of 1940 to Financial Advisors to Municipal Bond Issuers, Division of Investment Management*, SEC Staff Legal Bulletin No. 11 (Sept. 19, 2000), *available at* http://www.sec.gov/interps/legal.shtml.

16 *See* Release 3221, *infra* note 46, at n.76.

17 The term "bank" is defined in section 202(a)(2) of the Act. In 2001, the Act's definition of "investment adviser" was amended so that banks and bank holding companies are not eligible for this exclusion to the extent that they serve or act as an investment adviser to a registered investment company. However, if, in the case of a bank, such services or actions are performed through a separately identifiable department or division, the department or division, and not the bank itself, is deemed to be the investment adviser. The term "separately identifiable department or division" is defined in section 202(a)(26).

18 *Letter to Rep. William J. Hughes from Stanley B. Judd, Deputy Chief Counsel, Division of Investment Management*, SEC (June 4, 1980).

19 *First Commerce Investors, Inc*., SEC Staff No-Action Letter (Jan. 31, 1991); *Southwest Corporate Federal Credit Union*, SEC Staff No-Action Letter (May 31, 1983).

determine the professional's usual charge.[20]

3. *Brokers and Dealers*. A broker or dealer that is registered with the SEC under the Securities and Exchange Act of 1934 ("Exchange Act") is excluded from the Act if the advice given is: (i) solely incidental to the conduct of its business as broker or dealer, and (ii) it does not receive any "special compensation" for providing investment advice.

   a. *Solely Incidental.* The SEC has stated that investment advice is "solely incidental" to brokerage services when the advisory services rendered are "in connection with and reasonably related to the brokerage services provided."[21] If advice is not "solely incidental," a broker-dealer is subject to the Advisers Act regardless of the form of compensation it receives.

   b. *Special Compensation.* Generally, to avoid receiving "special compensation," a broker or dealer relying on this exclusion must receive only commissions, markups, and markdowns.[22]

      Bundled Fees. The SEC has stated a broker or dealer that receives a fee based on a percentage of assets that compensates the broker or dealer for both advisory and brokerage services receives "special compensation."[23]

      Separate or Identifiable Charge. The SEC has stated that a broker-dealer charges "special compensation" when it charges its customer a separate fee for investment advice, or when it charges its customers different commission rates, one with advice and one without, because the difference represents a clearly definable charge for investment advice.[24]

      Broker-Dealer Agents. The SEC staff has stated that a registered representative of a broker-dealer can rely on the exclusion if she is: (i) giving advice within the scope of her employment with the broker-

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20 Release 1092, *supra* note 3; *Henry S. Miller Companies of Dallas, Texas*, SEC Staff No-Action Letter (Feb. 21, 1975).

21 *Certain Broker-Dealers Deemed Not To Be Investment Advisers*, Investment Advisers Act Release No. 2376 (Apr. 12, 2005) ("Release 2376"), *available at* http://www.sec.gov/rules/final/34-51523.pdf.

22 Section 202(a)(11)(C). *See* S. Rep. No. 76-1775 at 22; H.R. Rep. No. 76-2639 at 28 (the term "investment adviser" was "so defined as specifically to exclude . . . brokers (insofar as their advice is merely incidental to brokerage transactions for which they receive only brokerage commissions.")).

23 In Release 2376, the SEC adopted a rule that, among other things, deemed brokers charging asset-based brokerage fees (rather than commissions, mark-ups, or mark-downs) not to be investment advisers based solely on their receipt of special compensation. The rule was vacated for other reasons by a federal court in March 2007. *Financial Planning Association v. SEC*, 482 F.3d (D.C. Cir. 2007). *See also National Regulatory Services*, SEC Staff No-Action Letter (Dec 2, 1992) at n.3.

24 *Final Extension of Temporary Exemption from the Investment Advisers Act for Certain Brokers and Dealers*, Investment Advisers Act Release No. 626 (Apr. 27, 1978) ("Release 626"). *See also, Opinion of the General Counsel Relating to Section 203(b)(3)of the Investment Advisers Act of 1940*, Investment Advisers Act No. 2 (Oct. 28, 1940). The Commission proposed to codify this interpretation in a rule. *See Interpretive Rule under the Advisers Act Affecting Broker-Dealers*, Investment Advisers Act Release No. 2652 (Sept. 24, 2007).

dealer; (ii) the advice is incidental to her employer's brokerage activities; and (iii) she receives no special compensation for her advice.[25]

Brokerage Customers. The SEC has stated that a broker-dealer does not have to treat its brokerage customers to whom it provides investment advice as advisory clients simply because it is registered under the Advisers Act. It must treat as an advisory client only those accounts for which it provides advice (*i.e.*, non-incidental advice) or receives compensation (*i.e.*, special compensation) that subjects the broker-dealer to the Advisers Act.[26]

4. *Publishers.* Publishers are excluded from the Act, but only if a publication: (i) provides only impersonal advice (*i.e.,* advice not tailored to the individual needs of a specific client);[27] (ii) is "bona fide," (containing disinterested commentary and analysis rather than promotional material disseminated by someone touting particular securities); and (iii) is of general and regular circulation (rather than issued from time to time in response to episodic market activity).[28]

5. *Government Securities Advisers.* This exclusion is available to persons and firms whose advice is limited to certain securities issued by or guaranteed by the U.S. government.[29]

6. *Credit Rating Agencies*. This exclusion is available to any rating agency regulated under section 15E of the Exchange Act as a "nationally recognized statistical rating organization."[30]

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[25] *Institute of Certified Financial Planners*, SEC Staff No-Action Letter (Jan. 21, 1986).

[26] Release 626, *supra* note 24. The Commission has proposed to codify this interpretation in a rule. *See Interpretive Rule under the Advisers Act Affecting Broker-Dealers, supra* note 24.

[27] *See Weiss Research, Inc., et al*, Investment Advisers Act Release No. 2525 (June 22, 2006) (newsletter publisher deemed to be an investment adviser providing personalized investment advice whose "auto-trading" program sent signals to broker-dealer, which automatically traded subscriber/customer securities consistent with signals).

[28] Section 202(a)(11)(D). *See Lowe v. SEC*, 472 U.S. 181 (1985); *SEC v. Gun Soo Oh Park, A/K/A Tokyo Joe, and Tokyo Joe's Societe Anonyme Corp.*, 99 F. Supp. 2d 889 (N.D. Ill. 2000). If a publisher is required to register as a result of some other advisory activity, the adviser is subject to all of the provisions of the Act and SEC rules with respect to the publication. *See* Investment Advisers Act Release No. 870 (July 15, 1983)("Release 870").

[29] Section 202(a)(11)(E). The scope of the exception includes persons whose advice is limited to: (i) direct obligations of the Federal government (*e.g*., U.S. Treasury obligations); (ii) securities subject to guarantees from the Federal government; and (iii) securities issued by or guaranteed by corporations whose securities are designated by the Secretary of the Treasury as exempt from the Exchange Act. The SEC staff has stated that advice about repurchase agreements collateralized by U.S. government securities does not fall within the exception. *J.Y. Barry Arbitrage Management, Inc*., SEC Staff No-Action Letter (Oct. 18, 1989). *See also In the Matter of Rauscher Pierce Refsnes, Inc., et al.*, Investment Advisers Act Release No. 1863 (Apr. 6, 2000) ("Because Rauscher's advice was not limited to Treasury securities or other government securities as described in section 202(a)(11)(E), that provision did not operate to exclude Rauscher from the definition of investment adviser.").

[30] Section 202(a)(11)(F), containing this exclusion for rating agencies, was added to the Act by the Credit Rating Agency Reform Act of 2006. Pub. L. No. 109-291, 120 Stat. 1327 (Sept. 29, 2006).

7. *Family Offices.* A family office that manages the wealth and other affairs of a single family is excluded from the investment adviser definition if it: (i) provides investment advice only to family clients; (ii) is wholly owned by family clients and exclusively controlled by family members and/or certain family entities; and (iii) does not hold itself out[31] to the public as an investment adviser.[32]

    a. *Family Members.* A family office's "family members" include all lineal descendants (including adopted children, stepchildren, foster children, and, in some cases, persons who were minors when a family member became their legal guardian) of a common ancestor (no more than 10 generations removed from the youngest generation of family members), and such lineal descendants' spouses or spousal equivalents.[33]

    b. *Family Clients.* The family office's clients generally may include family members; key employees; any non-profit or charitable organization funded exclusively by family clients; any estate of a family member, former family member, key employee, or subject to certain conditions, a former key employee; certain family client trusts; and any company wholly owned by and operated for the sole benefit of family clients.[34]

8. *Governments and Political Subdivisions.* The Act does not apply to the U.S. government, state governments and their political subdivisions, and their agencies or instrumentalities, including their officers, agents, or employees acting in their official capacities.[35]

9. *Non-U.S. Advisers.* There is no exemption for non-U.S. advisers. Non-U.S. persons advising U.S. persons are subject to the Act and must register under the Act[36] unless eligible for one of the exemptions discussed below (*e.g.*, the "foreign private adviser" registration exemption).[37] The SEC does not accept "home state registration" of non-U.S. advisers in lieu of SEC

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31 *See infra* notes 69 to 72 and accompanying text for discussion of "holding out."

32 Rule 202(a)(11)(G)-1(b)(defining "family office" for purpose of section 202(a)(11)(G), which was added to the Act by the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) ("Dodd-Frank Act")). Family offices that do not meet these conditions must register with the SEC unless another exemption is available. Rule 202(a)(11)(G)-1(e)(2).

33 Rule 202(a)(11)(G)-1(d)(6).

34 Rule 202(a)(11)(G)-1(d)(4). Key employees include executive officers, directors, trustees, general partners, or any person serving in a similar capacity for the family office or its affiliated family office, and certain employees who have participated in the investment activities of the family office or its affiliated family office for at least 12 months. Rule 202(a)(11)(G)-1(d)(8).

35 Section 202(b).

36 *In the Matter of Banco Espirito Santo S.A.*, Investment Advisers Act Release No. 3304 (Oct. 24, 2011) (The SEC brought an enforcement action against a commercial bank headquartered in Portugal for violating section 203(a) by marketing its portfolio of financial services, including offering securities and providing advice regarding those securities, to U.S. residents who were primarily Portuguese immigrants without registering with the Commission.).

37 *See* Section III. B. 3 of this outline for discussion of the foreign private adviser exemption.

registration.[38]

The SEC has authority to designate, by rule or order, other persons who are not within the intent of the definition of investment adviser.[39]

III. Which Investment Advisers Must Register Under the Advisers Act?

A firm that falls within the definition of "investment adviser" (and is not eligible for one of the exclusions) must register under the Advisers Act, unless it (i) is prohibited from registering under the Act because it is a smaller firm regulated by one or more of the states or (ii) qualifies for an exception from the Act's registration requirement.[40] All advisers, registered or not, are subject to the Act's anti-fraud provisions.

A. Prohibitions from Registration

Until 1996, most investment advisers were subject to regulation by both the SEC *and* one or more state regulatory agencies. The Act was amended in 1996 and again in 2010 to allocate regulatory responsibility between the SEC and the states.[41] Today, most small advisers and "mid-sized advisers" are subject to state regulation of advisers and are *prohibited* from registering with the SEC.[42] Most large advisers (unless an exemption is available) must register with the SEC, and state adviser laws are preempted for these advisers.[43]

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38 On June 12, 2007, the SEC held a "roundtable discussion" at which the possibility of revising its approach to mutual recognition was discussed. The SEC press release concerning the roundtable stated that "selective mutual recognition would involve the SEC permitting certain types of foreign financial intermediaries to provide services to U.S. investors under an abbreviated registration system, provided those entities are supervised in a foreign jurisdiction under a securities regulatory regime substantially comparable (but not necessarily identical) to that in the United States." *See* http://www.sec.gov/spotlight/mutualrecognition.htm.

39 Section 202(a)(11)(H). *See, e.g., International Bank for Reconstruction and Development and International Development*, Investment Advisers Act Release Nos. 1971 (Sept. 4, 2001) (notice) and 1955 (July 27, 2001) (order) (declaring World Bank instrumentalities not to be investment advisers under the Act). Section 202(a)(11)(H) had been designated as section 202(a)(11)(F) until 2006, and as 202(a)(11)(G) until 2011, when it was re-designated by the Dodd-Frank Act.

40 Section 203(a).

41 *National Securities Markets Improvements Act of 1996* ("NSMIA"), Pub. L. No. 104-290, 110 Stat. 3416 (1996); Dodd-Frank Act, *supra* note 32. Most of the provisions amending the Advisers Act to allocate regulatory responsibilities between the SEC and state governments have been codified in section 203A.

42 Section 203A(a). Section 203A creates a *prohibition*, not an exemption. *See In the Matter of Matthew P. Brady*, Investment Advisers Act Release No. 2178 (Sept. 30, 2003); *In the Matter of Warwick Capital Management Inc*., Initial Decision Release No. 327 (Feb. 15, 2007); *Credit Agricole Asset Management Alternative Investments, Inc*., SEC Staff No-Action Letter (Aug. 7, 2006). *See also In the Matter of Royal Oak Capital Management, LLC*, Investment advisers Act Release No. 3354 (Jan. 17, 2012) (cancelling the registration of an adviser that did not have required amount of assets under management to remain registered with the SEC).

43 *See* Sections 203(a) (registration required) and 203A(b) (preemption of state law).

1. *Operation of Section 203A of the Advisers Act*

   a. *Small Advisers.* Advisers with less than $25 million of assets under management are regulated by one or more states *unless* the state in which the adviser has its principal office and place of business has not enacted a statute regulating advisers.[44] Thus, unless an exemption is available (discussed below), only a small adviser with its principal office and place of business in Wyoming (which has not enacted a statute regulating advisers) may register with the SEC.

   b. *Mid-Sized Advisers.* Generally advisers with between $25 million and $100 million of assets under management[45] are regulated by one or more states if (i) the adviser *is registered* with the state where it has its principal office and place of business (*e.g.*, it cannot take advantage of an exemption from state registration), and (ii) the adviser is "subject to examination" by that state securities authority.[46] Unless an exemption is available, a mid-sized adviser with its principal office and place of business in New York or Wyoming is not "subject to examination" and must register with the SEC.[47]

   c. *Non-U.S. Advisers.* Advisers whose principal office and place of business is outside the United States are not prohibited from registering with the SEC and thus are not subject to the assets under management thresholds.[48] A non-U.S. adviser giving advice to U.S. persons[49] must register with the SEC (and thus may avoid registration with state regulators), unless an exemption from registration is

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44 Section 203A(a)(1) prohibits any adviser from registering with the SEC that is *regulated or is required to be regulated* in the state in which it maintains its principal office and place of business. The SEC interprets this provision to mean the prohibition applies only to an adviser that maintains its principal office and place of business in a state that has enacted an investment adviser statute. *Rules Implementing Amendments to the Investment Advisers Act of 1940*, Investment Advisers Act Release No. 1633 (May 15, 1997) ("Release 1633") at n.83 and accompanying text.

45 The Dodd-Frank Act raised the threshold for advisers to register with the SEC to $100 million of assets under management. *See* section 410 of Dodd-Frank Act. A mid-sized adviser *may* register when it acquires $100 million of assets under management and *must* register once it obtains $110 million of assets under management, unless some other exemption is available. Rule 203A-1(a)(1). Once registered with the SEC, a mid-sized adviser is not required to withdraw from SEC registration and register with the states until the adviser has less than $90 million of assets under management. *Id.*

46 Section 203A(a)(2) prohibits a mid-sized adviser from registering with the SEC if the adviser is required to be registered as an adviser in the state where it has its principal office and place of business and is subject to examination by that state. *See Rule Implementing Amendments to the Investment Advisers Act of 1940*, Investment Advisers Act Release No. 3221 (June 22, 2011) ("Release 3221").

47 *See* Instructions for Item 2 of Part 1A of Form ADV; Division of Investment Management: Frequently Asked Questions Regarding Mid-Sized Advisers, *available at* www.sec.gov/divisions/investment/midsizedadviserinfo.htm. New York and Wyoming did not advise the SEC staff that advisers registered with them are subject to examination. *See* Release 3221 at n.152, *supra* note 46.

48 *See* Release 1633, *supra* note 44 at Section II. E. An adviser with a principal office and place of business in another country does not have a principal office and place of business in a U.S. state that regulates investment advisers.

49 *See infra* note 64 for discussions of the definition of a "U.S. person."

available (in which case it may be subject to state registration requirements).[50]

2. *Exceptions to Prohibition.* Section 203A and SEC rules carve out several exceptions from the assets under management tests.

   a. *Advisers to Investment Companies.* Advisers to investment companies registered under the Investment Company Act of 1940 (the "Investment Company Act") must register with the SEC.[51] The exception is not available to an adviser that simply gives advice about investing in investment companies.[52]

   b. *Advisers to Business Development Companies*. Advisers with at least $25 million of assets under management that advise a company which has elected to be a business development company pursuant to section 54 of the Investment Company Act must register with the SEC.[53]

   c. *Pension Consultants*. Advisers providing advisory services to employee benefit plans having at least $200M of assets may register with the SEC (even though the consultant does not itself have those assets under management).[54]

   d. *Related Advisers.* Advisers that control, are controlled by, or are under common control of an SEC-registered adviser may register with the SEC, but only if they have the same principal office and place of business.[55]

   e. *Newly-Formed Advisers.* Advisers that are not registered, and have a reasonable expectation that they will be eligible for SEC registration within 120 days of registering, may register with the SEC.[56]

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[50] *See* Section III. A. 3 of this outline for discussion of exemption from registration for foreign private advisers.

[51] Sections 203A(a)(1)(B); 203A(a)(2)(A).

[52] *See* Instructions for Item 2 of Part 1A of Form ADV.

[53] Section 203A(a)(2)(A). *See also* Item 2.A.(6) of Part 1A of Form ADV.

[54] Rule 203(A)-2(a). In June 2011, the SEC increased the plan assets threshold required for pension consultants from $50 million to $200 million. *See* Release 3221, *supra* note 46. In May 2005, the SEC staff published a report detailing concerns with conflicts of pension fund consultants who help pension managers evaluate money managers. *See Staff Report Concerning Staff Examinations of Certain Select Pension Fund Consultants, available at* www.sec.gov/news/studies/pensionexamstudy.pdf. The SEC settled an administrative proceeding with a pension consultant that breached its fiduciary obligations by failing to disclose conflicts of interest. *In the Matter of Yanni Partners, Inc.*, Investment Advisers Act Release No. 2643 (Sept. 4, 2007) (pension consultant held itself out to be "independent" of money managers sold subscriptions to data base to money managers it was evaluating).

[55] Rule 203A-2(b).

[56] Rule 203A-2(c). An adviser relying on this exception must file an amendment to its Form ADV at the end of the 120 days indicating whether it has become eligible for SEC registration, or must withdraw its SEC registration. An adviser that expects to be eligible for SEC registration because of the amount of its assets under management must have $100M or more of assets under management no later than 120 days after its registration is declared effective. *See* Instructions for Item 2 of Part 1A of Form ADV.

f. *Multi-State Advisers*. Advisers that would otherwise be obligated to register with 15 or more states may register with the SEC.[57]

g. *Internet Advisers.* Certain advisers who provide advice though an interactive web site may register with the SEC.[58]

3. *State Law Still Applicable to SEC-Registered Advisers.* Although state investment adviser statutes do not apply to SEC-registered advisers, other state laws, including other state securities laws, do apply. In addition, state laws may (and most state laws continue to) require an SEC-registered adviser to:

a. comply with state anti-fraud prohibitions;

b. provide the state regulator with a copy of its SEC registration;

c. pay state licensing and renewal fees; and

d. license persons giving advice on behalf of the adviser, but only if the person has a place of business in the state.[59]

4. *Federal Anti-Fraud Law Still Applicable to State-Registered Advisers*. The SEC continues to institute enforcement actions against state-registered advisers charging violations of section 206 of the Act.[60]

B. Exemptions from Registration

The Advisers Act provides several exemptions from registration. The exemptions are voluntary; advisers eligible for them can nonetheless register with the SEC.[61]

1. *Intrastate Advisers*. Available to an adviser (i) all of whose clients are residents of the state in which the adviser maintains its principal office and place of business and (ii) that does not give advice about securities on any

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57 Section 203A(a)(2)(A); Rule 203A-2(d).

58 Rule 203A-2(e). *Exemption for Certain Investment Advisers Operating Through the Internet*, Investment Advisers Act Release No. 2091 (Dec. 12, 2002), *available at* http://www.sec.gov/rules/final/finalarchive/finalarchive2002.shtml.

59 SEC-registered advisers can comply with state requirements that they provide states with a copy of their registration (so-called "notice filings"), pay state registration fees, and license advisory personnel (in most states) through the electronic filing system (IARD) discussed below.

60 *See, e.g.*, *In the Matter of James William Fuller*, Investment Advisers Act Release No. 1842 (Oct. 4, 1999); *In the Matter of Robert Radano*, Investment Advisers Act Release No. 2750 (June 30, 2008); *SEC v. Aaron Donald Vallett and A.D. Vallett & Co., LLC*, Litigation Release No. 21557 (June 16, 2010). Most of the anti-fraud rules adopted by the SEC pursuant to its authority under section 206(4) of the Act (and discussed below) are not applicable to state-registered advisers. States have, however, adopted similar rules in many cases.

61 Persons who voluntarily register under the Advisers Act, in circumstances where their registration may not be required, are subject to all of the provisions and rules under the Advisers Act applicable to persons required to register. *See* Release 870, *supra* note 28. State regulatory law is not preempted for an adviser taking advantage of one of the exceptions from registration and thus the adviser may be required to register with one or more state securities regulators. *See* discussion of state preemption in Section III. A. of this outline.

national exchange.[62]

Updated →2. *Advisers to Insurance Companies*. Available to an adviser whose only clients are insurance companies.[63]

3. *Foreign Private Advisers.* Available to an adviser that (i) has no place of business in the United States; (ii) has, in total, fewer than 15 clients in the United States *and investors* in the United States in private funds advised by the adviser; (iii) has aggregate assets under management attributable to these clients and investors of less than $25 million; and (iv) does not hold itself out generally to the public in the United States as an investment adviser.[64]

The exemption for foreign private advisers was added by the Dodd-Frank Act and replaces the private adviser exemption (i.e., an exemption for any adviser with fewer than 15 clients) previously provided by the same section of the Act, which was repealed. The SEC incorporated many of the rules from "old" section 203(b)(3).

a. *Counting Clients*

(i) *Multiple Persons as a Single Client.* Rule 202(a)(30)-1 provides that the following can be considered a single client:[65]

(A) a natural person and (i) any minor child of the natural person; (ii) any relative, spouse, spousal equivalent, or relative of the spouse or of the spousal equivalent of the natural person with the same principal residence; and (iii) all accounts or trusts of which the persons described above are the only primary beneficiaries; or

(B) a corporation, general or limited partnership, limited liability company, trusts or other legal organization that receives investment advice based on its investment objectives (rather than the individual investment objectives of its owners),[66]

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62 Section 203(b)(1). The SEC staff takes the position that advice regarding investment companies involves advice about "listed securities" if the investment company invests in listed securities. *Roy Heybrock*, SEC Staff No-Action Letter (Apr. 5, 1992).

63 Section 203(b)(2). *See also TACT Asset Mgmt., Inc.*, SEC Staff No-Action Letter (Oct. 24, 2012) (stating that the staff would not recommend enforcement proceedings if a U.S. investment adviser whose only client is a foreign insurance company does not register with the SEC).

64 Section 203(b)(3) (exempting "any investment adviser that is a foreign private adviser"); Section 202(a)(30) (defining a "foreign private adviser"). Rule 202(a)(30)-1 defines the term "in the United States" by reference to the definitions of a "U.S. person" and the "United States" in Regulation S under the Securities Act, except that the rule treats as "in the United States" any discretionary account owned by a U.S. person and managed by a non-U.S. affiliate of the adviser. An adviser must assess whether a person is "in the United States" at the time the person becomes a client or, in the case of an investor in a private fund, each time the investor acquires securities issued by the fund. *See* rule 202(a)(30)-1, at note to paragraph (c)(3)(i).

65 Rule 202(a)(30)-1. The rule provides a non-exclusive safe harbor for counting clients for purposes of section 203(b)(3). *See* rule 202(a)(30)-1, at note to paragraphs (a) and (b).

66 An adviser must count an owner (*e.g.*, a limited partner) as a client if it provides advice to that owner "separate and apart" from the advice provided to the entity. Rule 202(a)(30)-1(b)(1). *Cf. Latham &*

and two or more of these entities that have identical owners.

(ii) "*Look through" private funds.* An adviser must count both its direct clients and each investor in any "private fund" it advises.

No Double Counting. An adviser may treat as a single investor any person who is an investor in two or more of the adviser's private funds.[67]

Nominal Holders. An adviser may be required to also "look through" persons who are nominal holders of a security issued by a private fund to count the investors in the nominal holder when determining if the adviser qualifies for the exemption. For example, holders of the securities of any feeder fund in a master-feeder arrangement may be deemed to be the investors of the master fund.[68]

b. *Holding Out.* The SEC staff views a person as holding himself out as an adviser if he advertises as an investment adviser or financial planner, uses letterhead indicating activity as an investment adviser, or maintains a telephone listing or otherwise lets it be known that he will accept new advisory clients,[69] or hires a person to solicit clients on his behalf.[70]

(i) *Participation in Non-Public Offerings*. Foreign private advisers will not be deemed to be holding themselves out generally to the public in the United States as an investment adviser solely because they participate in a non-public offering in the United States of securities issued by a private fund pursuant to an exemption from registration under the Securities Act of 1933.[71]

(ii) *Use of the Internet.* An adviser using the Internet to provide information about itself ordinarily would be "holding itself out" as an adviser. However, the SEC has stated that it will not consider a non-U.S. adviser, including foreign private advisers, to be holding itself out as an adviser if:

(A) *Prominent Disclaimer*. The adviser's web site includes a

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Watkins, SEC Staff No-Action Letter (Aug. 24, 1998); *Burr, Egan, Deleage & Co., Inc.*, SEC Staff No-Action Letter (Apr. 27, 1987).

67 Rule 202(a)(30)-1, at note to paragraph (c)(2).

68 *Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers*, Investment Advisers Act Release No.3222 (June 22, 2011)("Release 3222") at Section II.C.2.

69 *See, e.g., William Bloor*, SEC Staff No-Action Letter (Feb. 15, 1980); *Richard J. Shaker*, SEC Staff No-Action Letter (Aug. 1, 1977); *Al O'Brien Associates*, SEC Staff No-Action Letter (Oct. 6, 1973).

70 Investment Advisers Act Release No. 688 (July 15, 1979) at n.9. *See also Lamp Technologies, Inc.*, SEC Staff No-Action Letter (May 29, 1997) (investment adviser not "holding itself out generally to the public as an investment adviser" solely by virtue of posting information about certain private funds (*e.g.*, hedge funds) on a password-protected web site that is accessible only by accredited investors).

71 Rule 202(a)(30)-1(d).

prominent disclaimer making it clear that its web site materials are not directed to U.S. persons; and

(B) *Procedures.* The adviser implements procedures reasonably designed to guard against directing information about its advisory services to U.S. persons (*e.g.*, obtaining residency information before sending further information).[72]

4. *Charitable Organizations and Plans.* Available to an adviser that is a charitable organization or a charitable organization's employee benefit plan, including a trustee, officer, employee, or volunteer of the organization or plan to the extent that the person is acting within the scope of his employment or duties.[73]

5. *Commodity Trading Advisors*

   a. *Generally.* Available to any adviser that is registered with the U.S. Commodity Futures Trading Commission ("CFTC") as a commodity trading advisor and whose business does not consist primarily of acting as an investment adviser and that does not advise a registered investment company or a business development company.[74]

   b. *Commodity Trading Advisors to Private Funds.* Available to any adviser registered with the CFTC as a commodity trading advisor that advises a private fund, provided that the adviser must register with the SEC if its business becomes predominantly the provision of securities-related advice.[75]

6. *Private Fund Advisers*. Available to an adviser solely to private funds that has less than $150 million in assets under management in the United States.[76] An adviser that has any other type of client is not eligible for the exemption.[77]

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[72] *Statement of the Commission Regarding Use of Internet Web Sites to Offer Securities, Solicit Securities Transactions or Advertise Investment Services Offshore*, Investment Advisers Act Release No. 1710 (Mar. 23, 1998) section VI, *available at* http://www.sec.gov/rules/interp/interparchive/interparch1998.shtml.

[73] Sections 203(b)(4) and (5) were added by the *Philanthropy Protection Act of 1995*, Pub. L. No. 104-62, 109 Stat. 682 (1995). *See also Sisters of Mercy*, SEC Staff No-Action Letter (Oct. 1, 2009).

[74] Section 203(b)(6) (re-designated as 203(b)(6)(A) by Dodd-Frank Act) was added by the *Commodity Futures Modernization Act of 2000*, Pub. L. No. 106-554, 114 Stat. 2763 (2000), which also amended the Act's definition of "security" in section 202(a)(18) of the Act to include certain "securities futures." The Act repealed the ban on single stock or narrow-based stock index futures and established a framework for shared jurisdiction over the trading of these instruments and market participants. *See* Exchange Act Release No. 44288 (May 9, 2001), *available at* http://www.sec.gov/rules/proposed/34-44288.htm.

[75] Section 203(b)(6)(B) of the Advisers Act (added by the Dodd-Frank Act).

[76] Section 203(m) of the Advisers Act (added by the Dodd-Frank Act). The SEC adopted rule 203(m)-1 on June 22, 2011 to implement the section. *See* Release 3222, *supra* note 68.

[77] Two nominally separate but related advisers may be considered to be one adviser (and their assets aggregated) if they do not operate sufficiently independent of one another.

a. *Private Funds.* A "private fund" is an issuer of securities that would be an investment company "but for" the exceptions provided for in section 3(c)(1) or 3(c)(7) of the Investment Company Act.[78]

(i) Section 3(c)(1) is available to a fund that does not publicly offer its securities and has 100 or fewer beneficial owners of its outstanding securities.

(ii) Section 3(c)(7) is available to a fund that does not publicly offer its securities and limits its owners to qualified purchasers.[79]

b. *Calculating Private Fund Assets*

(i) *Method of Calculation*. Generally, advisers must include the value of all private funds managed, including the value of any uncalled capital commitments.[80] Value is based on market value of those assets, or the fair value of those assets where market value is unavailable, and must calculate the assets on a gross basis, *i.e.*, without deducting liabilities, such as accrued fees and expenses or the amount of any borrowing.[81]

(ii) *Annual Assessment.* An adviser must assess annually whether it has $150 million or more of private fund assets under management. An adviser that meets or exceeds the $150 threshold must register with the Commission.[82]

c. *Non-U.S. Advisers.* An adviser with a principal office and place of business outside the United States may exclude consideration of non-U.S. clients, *i.e.*, it may rely on the exemption if (a) *all* of its clients that are United States persons[83] are qualifying private funds; and (b) any management at a U.S. place of business by the adviser is solely

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78 Section 202(a)(29) of the Advisers Act.

79 The term "qualified purchasers" is defined in section 2(a)(51) of the Investment Company Act.

80 Form ADV: Instructions for Part 1A, instr. 5.b.(4). Proprietary assets, *i.e*, those of the adviser or its principals may not be excluded. Form ADV: Instructions for Part1A, instr. 5.b.(1).

81 *Id.* The SEC has recognized that, although many advisers will calculate the fair value of their private fund assets in accordance with Generally Accepted Accounting Principles ("GAAP") or another international accounting standard, other advisers acting consistently and in good faith may utilize another fair valuation standard. Release 3222, *supra* note 68 at nn.364-365 and accompanying text. Consistent with this good faith requirement, the SEC expects that an adviser that calculates fair value in accordance with GAAP or another basis of accounting for financial reporting purposes will also use that same basis for purposes of determining the fair value of its regulatory assets under management. *Id.* at n.365.

82 Rule 203(m)-1(c). A private fund adviser that had complied with all SEC reporting requirements applicable to an exempt reporting adviser, but reported in its annual updating amendment that fund assets exceeded $150 million, has up to 90 days after filing the annual updating amendment to apply for SEC registration, and may continue doing business as a private fund adviser during this time. General Instruction 15 to Form ADV.

83 Similar to the foreign private adviser exemption, a "United States person" generally is a "U.S. person," as defined in Regulation S under the Securities Act, except that a discretionary or other fiduciary account also is a "United States person" if the account is held for the benefit of a United States person by a non-U.S. fiduciary who is a related person of the adviser. Rule 203(m)-1(d)(8).

attributed to $150 million of private fund assets.[84]

d. *Annual Report.* An adviser relying on the private fund adviser exemption must annually file a report on Form ADV to the SEC [85] and is subject to examination. Other provisions of the Act and SEC rules applicable only to registered advisers do not apply. The SEC refers to these advisers as "exempt reporting advisers."

7. *Venture Capital Advisers.* Available to an adviser that solely advises one or more "venture capital funds" as defined by SEC rule (regardless of the amount of assets managed).[86]

a. *Definition*. To qualify as a "venture capital fund," a fund must be a "private fund"[87] that:

(i) represents to investors that the fund pursues a venture capital strategy;[88]

(ii) does not provide investors with redemption rights;[89]

(iii) holds no more than 20% of the fund's assets in non-"qualifying investments" (excluding cash and certain short-term holdings)

Qualifying investment means generally directly acquired investments in equity securities of private companies (generally, companies that at the time of investment have not made a public offering) and that do not incur leverage or borrow in connection with the venture capital fund investment and distribute proceeds of such borrowing to the fund (*i.e.*, have not been acquired in a leveraged buy-out transaction); and

(iv) does not borrow (or otherwise incur leverage) more than 15% of the fund's assets, and then only on a short-term basis (*i.e.*, for no more than 120-days).[90]

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84 Rule 203(m)-1(b)(1) and (2). The term "place of business" has the same meaning as in the exemption for foreign private advisers, discussed above. *See* Section III. B. 3. of this outline. Rule 203(m)-1(d)(2).

85 Rule 204-2. The report must be filed within 60 days of relying on the private fund adviser exemption. Only portions of Form ADV must be completed. General Instruction 13 to Form ADV. An exempt reporting adviser is not required to deliver a brochure to its clients. General Instruction 3 to Form ADV.

86 Section 203(l) of the Advisers Act (added by the Dodd-Frank Act). The SEC adopted rule 203(l)-1 on June 22, 2011 to implement the section. *See* Release 3222, *supra* note 68.

87 Rule 203(l)-1(a)(5). In addition, the fund cannot be registered under the Investment Company Act or have elected to be treated as a business development company as defined by that Act. Rule 203(l)-1(a)(5).

88 Rule 203(l)-1(a)(1).

89 Rule 203(l)-1(a)(4) (the rule permits exceptions in extraordinary circumstances).

90 Rule 203(l)-1 contains a grandfathering provision for certain private funds that have sold their initial interests in the fund by December 31, 2010, provided that they have represented to their investors that

b. *Non-U.S. Advisers.* The exemption is available to a non-U.S. adviser, but (unlike the private fund adviser exception) such an adviser may not disregard its non-U.S. advisory activities.[91] Thus, all of an adviser's clients, including non-U.S. clients, must be venture capital funds.[92]

c. *Annual Reporting.* An adviser relying on the venture capital adviser exemption must annually file a report on Form ADV to the SEC, [93] and is subject to examination. Other provisions of the Act and SEC rules applicable only to registered advisers do not apply. The SEC also refers to these advisers as "exempt reporting advisers."

8. *Advisers to Small Business Investment Companies ("SBICs").* SBICs, licensed by the Small Business Administration, are privately owned and managed investment firms that provide venture capital to small businesses from the SBIC's own capital and from funds the SBIC is able to borrow at favorable rates through the federal government.[94]

IV. Who Must Register Under the Advisers Act?

A. <u>The Advisory Firm</u>

Although many individuals who are employed by advisers fall within the definition of "investment adviser," the SEC generally does not require those individuals to register as advisers with the SEC. Instead, the advisory firm must register with the SEC. The adviser's registration covers its employees *and* other persons under its control, provided that their advisory activities are undertaken on the adviser's behalf.[95]

B. <u>Affiliates</u>

1. *Integration.* The SEC staff takes the view that advisers and their affiliates cannot circumvent the disclosure and other requirements of the Act by separately registering under the Act if they are operationally integrated, *e.g.*, have the same personnel, capital structures, and investment decision-making functions.[96]

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they pursue a venture capital strategy and that they do not issue any interests to any person after July 21, 2011.

91 Release 3222, *supra* note 68.

92 Rule 203(l)-1 contains a note the effect of which is to permit a non-U.S. adviser to treat a foreign fund it advises as a "private fund" even if the fund does not meet the Act's definition of a private fund because it is not relying on a statutory exemption from the Investment Company Act, but is rather relying on the lack of jurisdiction of the U.S. Release 3222, *supra* note 68.

93 Rule 204-2. *See supra* note 85 for a summary of reporting requirements.

94 Section 203(b)(7) (added by the Dodd-Frank Act).

95 Investment Advisers Act Release No. 688 (July 12, 1979) (persons associated with registered adviser need not separately register as investment advisers solely as a result of their activities as associated persons). *See also Kevin J. Hughes,* SEC Staff No-Action Letter (Dec. 7, 1983).

96 The determination of whether an advisory business of two separately formed affiliates may be required to be integrated is based on the facts and circumstances. Release 3222, *supra* note 68. *See Richard*

For example, an adviser managing $200 million of private fund assets could not simply reorganize as two separate advisers each of which purported to rely on the private fund adviser exemption from registration.[97]

2. *Participating Non-U.S. Affiliates*. The SEC staff takes the view that, under certain conditions, a non-U.S. adviser (a "participating affiliate") does not have to register under the Act if it provides advice to U.S. persons through a registered affiliate.[98] The conditions that must be satisfied include the following:

   a. an unregistered adviser and its registered affiliate must be separately organized;

   b. the registered affiliate must be staffed with personnel (located in the U.S. or abroad) who are capable of providing investment advice;

   c. all personnel of the participating affiliate involved in U.S. advisory activities must be deemed "associated persons"[99] of the registered affiliate; and

   d. the SEC must have adequate access to trading and other records of the unregistered adviser and to its personnel to the extent necessary to enable the SEC to monitor and police conduct that may harm U.S. clients or markets.[100]

   The Commission affirmed these staff positions in the context of the private adviser exemptions.[101]

3. *Joint Registration of Affiliates.*

   a. *Special Purpose Vehicles.* The SEC staff takes the position that a special purpose vehicle ("SPV") set up by a registered investment adviser to serve as the general partner of a pooled investment vehicle (*e.g.*, a hedge fund) does not have to separately register as an investment adviser if all of the activities of the SPV are subject to the registered adviser's supervision and control,[102] its employees are

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Ellis, SEC Staff No-Action Letter (Sept. 17, 1981); *Kenneth Levanthal*, SEC Staff No-Action Letter (Feb. 7, 1983). *See also Price Waterhouse*, SEC Staff No-Action Letter (Nov. 22, 1988).

97 Release 3222, *supra* note 68, at Section II.D.

98 *See Uniao de Bancos de Brasilerios, S.A.*, SEC Staff No-Action Letter (July 28, 1992); *Mercury Asset Management*, SEC Staff No-Action Letter (Apr. 16, 1993); *Kleinwort Benson Investment Management Ltd*., SEC Staff No-Action Letter (Dec. 15, 1993); *Murray Johnston Holdings Ltd*., SEC Staff No-Action Letter (Oct. 7, 1994). *See also* Section II. C. of Release 3222 and Section III. B. 3 of this outline regarding the exemption for foreign private advisers.

99 *See* Section V. A. 1 of this outline for the definition of "person associated with an investment adviser."

100 *See id*.

101 Release 3222, *supra* note 68, at Section II.D.

102 For guidance regarding application of the staff's position with respect to directors of an SPV that are independent of the investment adviser, *see American Bar Association Subcommittee on Hedge Funds*, SEC Staff Letter (Jan. 18, 2012) ("ABA Letter 2012"), Question 3, *available at* http://www.sec.gov/divisions/investment/noaction/2012/aba011812.htm.

treated as "supervised persons" of the registered adviser and reported as such on its Form ADV, and the SPV is subject to examination by the SEC.[103] The SEC staff takes the view that this analysis is not limited to a registered adviser with a single SPV.[104]

b. *Multiple Entities in Control Relationships.* The SEC staff has taken the position that an investment adviser may file (or amend) a single Form ADV on behalf of itself and each other adviser that is under common control with the filing adviser where the filing adviser and each relying adviser collectively conduct a "single advisory business."[105]

V. How Does an Investment Adviser Register Under the Advisers Act?

A. Procedure

Applicants for registration under the Act must file Form ADV with the SEC. Within 45 days the SEC must grant registration or institute an administrative proceeding to determine whether registration should be denied.

1. *Denial of Registration*. The SEC may deny registration if the adviser is subject to a "Statutory Disqualification," that is, if the adviser or any "person associated with the adviser" makes false or misleading statements in its registration application, has within the past 10 years been convicted of a felony, or if it has been convicted by a court or found by the SEC to have violated a securities-related statute or rule, or have been the subject of a securities-related injunction, or similar legal action.[106]

   Person Associated with An Investment Adviser. These include employees (other than clerical employees) of the advisers as well as any persons who directly or indirectly control the investment adviser or are controlled by the adviser.[107] The SEC can deny registration if, for example, the parent company of an adviser has been convicted of securities fraud even if the adviser and its employees have not.

   Non-U.S. Based Offenses. Statutory Disqualifications include convictions in

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103 *American Bar Association Subcommittee on Private Entities*, SEC Staff Letter (Dec. 8, 2005) ("ABA Letter 2005"), Question G1, *available at* http://www.sec.gov/divisions/investment/noaction/aba120805.htm.

104 ABA Letter 2012, Question 2. Similarly, under certain circumstances, the staff has indicated that an exempt reporting adviser to which a private fund's day-to-day management responsibility has been delegated may satisfy the Form ADV reporting obligations of one or more special purpose entities. *See* "FAQs" regarding Reporting to the SEC as an Exempt Reporting Adviser ("ERA FAQs") *available at* http://www.sec.gov/divisions/investment/iard/iardfaq.shtml#exemptreportingadviser.

105 *See id.* Question 4 (outlining the circumstances under which a filing adviser and one or more relying advisers would, in the staff's view, collectively conduct a single advisory business absent other factors suggesting that they conduct different businesses). Likewise, under certain circumstances, the staff has indicated that an exempt reporting adviser may satisfy the Form ADV reporting obligations of one or more special purpose entities under its control. *See* ERA FAQs.

106 Sections 203(c)(2) and (e).

107 Section 202(a)(17).

non-U.S. courts, and by findings of violations by "foreign financial regulatory authorities" enforcing non-U.S. laws.[108]

2. *Qualifications.* There are no "fit and proper" or educational requirements for registration as an investment adviser, although certain employees of the adviser may have to pass securities examinations in the states in which they have a principal place of business. Instead, advisers must disclose to clients the background and qualifications of certain of their personnel.[109]

B. Form ADV

Form ADV sets forth the information that the SEC requires advisers to provide in an application for registration. Once registered, an adviser must update the form at least once a year, and more frequently if required by instructions to the form.[110] Form ADV consists of two parts.[111]

1. *Part 1.* Part 1 is primarily for SEC use. It requires information about the adviser's business, ownership, clients, employees, business practices (especially those involving potential conflicts with clients), and any disciplinary events of the adviser or its employees. The SEC uses information from this part of the form to make its registration determination and to manage its regulatory and examination programs. Part 1 is organized in a check-the-box, fill-in-the-blank format.

   On June 22, 2011, the SEC amended Part 1A to expand the information collected, primarily from advisers to hedge funds and other private funds in order to improve the SEC's ability to oversee registered advisers. Amended Part 1A requires advisers to provide additional information about three areas of their operations: (i) additional information about private funds they advise; (ii) expanded data provided by advisers about their advisory business (including the types of clients they have, their employees, and their advisory activities), as well as about their business practices that may present significant conflicts of interest; (iii) additional information about advisers' non-advisory activities and their financial industry affiliations.[112]

2. *Part 2.* Amended in 2010, Part 2 is divided into Part 2A and Part 2B and sets forth information required in client brochures and brochure supplements.[113]

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108 Sections 203(c)(2) and (e). Non-U.S. based offenses were added to section 203(e) in 1990 by the International Securities Enforcement Cooperation Act of 1990, Pub. L. No. 101-550, 104 Stat. 2713 (Nov. 15, 1990).

109 Form ADV, Part 2B.

110 Rule 204-1(a).

111 Both Part 1 and Part 2A of the Form ADV are filed by registered advisers through the IARD system and are available to the public on the Investment Adviser Public Disclosure Website at http://www.adviserinfo.sec.gov/(S(hdqosw4svnoutoxsmgo4mizx))/IAPD/Content/IapdMain/iapd_SiteMap.aspx.

112 Release 3221, *supra* note 46.

113 On July 28, 2010, the SEC adopted amendments to Part 2 of Form ADV. Investment Advisers Act Release No. 3060 (July, 2010), *available at* http://www.sec.gov/rules/final/2010/ia-3060.pdf ("Part 2

Brochure Part 2A requires an adviser to prepare a narrative "brochure" that includes plain English disclosures of, among other things, the adviser's business practices, investment strategies, fees, conflicts of interest, and disciplinary information.[114] Part 2B requires an adviser to prepare a "brochure supplement" that contains information about each advisory employee that provides investment advice to its clients, including her educational background, business experience, other business activities, and disciplinary history. To satisfy the "brochure rule" (discussed below),[115] the adviser must deliver the brochure (and updates to that brochure) to its clients annually and the brochure supplement about a supervisory employee to a client at the time the employee begins to provide advisory services to that client.[116] In addition, the adviser must file its brochure, but not its brochure supplement, with the SEC to satisfy its registration requirements.[117]

C. Electronic Filing

All applications for registration as an adviser with the SEC must be submitted electronically through an Internet-based filing system called the Investment Adviser Registration Depository ("IARD").[118] The IARD is operated by the Financial Industry Regulatory Authority ("FINRA"), the broker-dealer self-regulator (formerly, NASD).[119]

D. Public Availability

All current information from advisers' Form ADVs filed with the SEC is publicly available through an SEC web-site: www.adviserinfo.sec.gov.

E. Withdrawal of Registration

Advisers withdraw from registration by filing Form ADV-W.[120] An adviser may withdraw from registration because it: (i) ceases to be an investment adviser; (ii) is entitled to an exception from the registration requirements; or (iii) no longer is eligible for SEC registration (*e.g.*, it no longer has the requisite amount of assets

Adopting Release"). For staff responses to frequently asked questions about the amended Part 2, visit the SEC's website at http://www.sec.gov/divisions/investment/form-adv-part-2-faq.htm ("Part 2 FAQs").

114 Prior to the 2010 amendments, Part II of Form ADV was in a check-the-box, fill-in-the-blank format.

115 Rule 204-3.

116 Rule 204-3(b)(3). For specific delivery requirements under the brochure rule, see Section VI. B. 12 below.

117 Rule 203-1(a); Rule 204-1(b)(1).

118 Rule 203-1(b). FINRA charges advisers filing fees to defray the cost of maintaining and operating the IARD. To pay the fees, advisers must establish and fund an account with FINRA before making a filing. A fee schedule is available at www.sec.gov/divisions/investment/iard/iardfee.shtml.

119 Rule 204-1(b). For information about electronic filing by advisers, *see* www.sec.gov/iard. FINRA does not act as a self-regulatory organization with respect to investment advisers.

120 Rule 203-2. Form ADV-W filings are made electronically through the IARD, and are effective immediately. There are no filing fees for Form ADV-W.

under management).[121] The SEC also has the authority under section 203(f) of the Advisers Act to revoke the registration of an adviser under certain enumerated circumstances.

F. Successor Registrations

An unregistered person that assumes and continues the business of a registered investment adviser (which then ceases to do business) may rely on the registration of the investment adviser by filing an application for registration within 30 days of the succession.[122]

VI. What Are the Requirements Applicable to a Registered Investment Adviser?

The Advisers Act does not provide a comprehensive regulatory regime for advisers, but rather imposes on them a broad fiduciary duty to act in the best interest of their clients. As the Commission explained:

> Unlike the laws of many other countries, the U.S. federal securities laws do not prescribe minimum experience or qualification requirements for persons providing investment advice. They do not establish maximum fees that advisers may charge. Nor do they preclude advisers from having substantial conflicts of interest that might adversely affect the objectivity of the advice they provide. Rather, investors have the responsibility, based on disclosure they receive, for selecting their own advisers, negotiating their own fee arrangements, and evaluating their advisers' conflicts.[123]

There are five types of requirements on an adviser: (i) fiduciary duties to clients; (ii) substantive prohibitions and requirements; (iii) contractual requirements; (iv) recordkeeping requirements; and (v) administrative oversight by the SEC, primarily by inspection.

A. Fiduciary Duties to Clients

Fundamental to the Act is the notion that an adviser is a fiduciary. As a fiduciary, an adviser must avoid conflicts of interest with clients and is prohibited from overreaching or taking unfair advantage of a client's trust. A fiduciary owes its clients more than mere honesty and good faith alone. A fiduciary must be sensitive to the conscious and unconscious possibility of providing less than disinterested advice, and it may be faulted even when it does not intend to injure a client and even if the client does not suffer a monetary loss.[124] The landmark

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[121] Before withdrawing from registration, an adviser must arrange for the preservation of records it is required to keep under the Act. Rule 204-2(f).

[122] Section 203(g). *See* Instruction 4 to Part 1A of Form ADV; *Registration of Successors to Broker-Dealers and Investment Advisers*, Investment Advisers Act Release No. 1357 (Dec. 28, 1992) (the provision in rule 203-1 referred to in Release 1357 that addressed successions was moved by the SEC to Instruction 4 to Form ADV in 2000). A succession resulting from a change in the place or form of organization, or composition of a partnership, *i.e.*, a succession that does not involve a change of control, may be completed by amending the predecessor's Form ADV promptly after the succession. *Id.*

[123] *See Amendments to Form ADV*, Investment Advisers Act Release No. 2711 (Mar. 3, 2008).

[124] *SEC v. Capital Gains Research Bureau, supra* note 2, at 191-192.

court decision defining the duties of a fiduciary is Justice Cardozo's opinion in *Meinhard v. Salmon,* in which he explains that:

> Many forms of conduct permissible in the workaday world for those acting at arm's length are forbidden by those bound by fiduciary ties. A fiduciary is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.[125]

These concepts are embodied in the anti-fraud provisions of the Advisers Act. As the Supreme Court stated in *SEC v. Capital Gains Research Bureau, Inc.*, its seminal decision on the fiduciary duties of an adviser under the Act:

> [t]he Investment Advisers Act of 1940 reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested.[126]

The duty is not specifically set forth in the Act, established by SEC rules, or a result of a contract between the adviser and the client (and thus it cannot be negotiated away). Rather, fiduciary duties are imposed on an adviser by operation of law because of the nature of the relationship between the two parties.[127] It is made enforceable by section 206 of the Act,[128] which contains the Act's anti-fraud provisions, and incorporated indirectly into the Act in various provisions and disclosure requirements discussed below.[129]

Several obligations flow from an adviser's fiduciary duties.

1. *Full Disclosure of Material Facts*. Under the Act, an adviser has an affirmative obligation of utmost good faith and full and fair disclosure of all facts material to the client's engagement of the adviser to its clients, as well as a duty to avoid misleading them.[130] Accordingly, the duty of an investment adviser to refrain from fraudulent conduct includes an obligation to disclose material facts to its clients whenever failure to do so would defraud or operate as a fraud or deceit upon any client.

   Conflicts of Interest. This disclosure of material facts is particularly pertinent whenever the adviser is faced with a conflict—or a potential

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125 164 N.E. 545, 546 (N.Y. 1928).

126 *SEC v. Capital Gains Research Bureau, supra* note 2, at 190-192.

127 *See In the Matter of Arleen W. Hughes*, Exchange Act Release No. 4048 (Feb 18, 1948).

128 *Transamerica Mortgage Advisors v. Lewis,* 444 U.S. 11 (1979) ("[T]he Act's legislative history leaves no doubt that Congress intended to impose enforceable fiduciary obligations.").

129 *See Morris v. Wachovia Securities, Inc.*, 277 F. Supp. 2d 622 (E.D. Va. 2003) ("§206(2) is more than an anti-fraud provision because it establishes fiduciary duties for investment advisers."). The scope of the fiduciary duties is determined by reference to federal court and administrative decisions rather than state common law analogies. *Laird v. Integrated Resources, Inc.,* 897 F.2d 826 (5th Cir. 1990) ("[B]ecause state law is not considered, uniformity is promoted.").

130 *See In the Matter of Arleen W. Hughes, supra* note 127.

conflict— of interest with a client. As a general matter, the SEC has stated that the adviser must disclose all material facts regarding the conflict so that the client can make an informed decision whether to enter into or continue an advisory relationship with the adviser, or take some action to protect himself or herself against the conflict.[131]

Disciplinary Events and Precarious Financial Condition. The SEC requires a registered adviser to disclose to clients and prospective clients material facts about:

a. a financial condition of the adviser that is reasonably likely to impair the adviser's ability to meet contractual commitments to clients;[132] and

b. certain disciplinary events of the adviser (and certain of its officers) occurring within the past 10 years, which are presumptively material.[133]

2. *Suitable Advice.* Advisers owe their clients a duty to provide only suitable investment advice. This duty generally requires an adviser to make a reasonable inquiry into the client's financial situation, investment experience and investment objectives, and to make a reasonable determination that the advice is suitable in light of the client's situation, experience and objectives.[134]

3. *Reasonable Basis for Recommendations*. An adviser must have a

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131 Part 2 Adopting Release, *supra* note 113. *See also SEC v. Capital Gains Research Bureau*, *supra* note 2, at 191-192 ("The Investment Advisers Act of 1940 thus reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship, as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested.").

132 Item 18 of Part 1A, Form ADV. This requirement is applicable to advisers that have discretionary authority with client accounts, or have custody of client assets, or require or solicit prepayment of more than $1,200 in fees per *client*, six months or more in advance.

133 Form ADV: Item 11 of Part 1A; Item 9 of Part 2A, and Item 3 of Part 2B.

134 *See Suitability of Investment Advice Provided by Investment Advisers*, Investment Advisers Act Release No. 1406 (Mar. 16, 1994). In that release, the SEC proposed a rule under the Act's anti-fraud provisions requiring advisers give clients only suitable advice. Although the rule was never adopted, SEC staff believes that the rule would have codified existing suitability obligations of advisers and, as a result, the proposed rule reflects the current obligation of advisers under the Act. Suitability obligations do not apply to impersonal investment advice, and compliance with the obligation is evaluated in the context of a client's overall portfolio. *Id*. "Thus, inclusion of some risky securities in the portfolio of a risk-averse client may not necessarily be unsuitable." *Id*. The SEC has instituted enforcement actions against advisers that provided unsuitable investment advice. *See In the Matter of George E. Brooks & Associates, Inc*., Investment Advisers Act Release No. 1746 (Aug. 17, 1998) (adviser failed to appropriately diversify, and effected unsuitable trades of speculative high risk stocks in, the discretionary accounts of customers with conservative investment objectives, many of whom were elderly and had little investment experience); *In the Matter of Philip A. Lehman,* Investment Advisers Act Release No. 1831 (Sept. 22, 1999) (alleging adviser recommended risky investment for customer's individual retirement account, despite customer's conservative investment objective and age).

reasonable, independent basis for its recommendations.[135]

4. *Best Execution.* Where an adviser has responsibility to direct client brokerage, it has an obligation to *seek* best execution of clients' securities transactions.[136] In meeting this obligation, an adviser must seek to obtain the execution of transactions for clients in such a manner that the client's total cost or proceeds in each transaction is the most favorable under the circumstances.[137] In assessing whether this standard is met, an adviser should consider the full range and quality of a broker's services when placing brokerage, including, among other things, execution capability, commission rate, financial responsibility, responsiveness to the adviser, and the value of any research provided.[138]

   Interpositioning. An adviser will generally not obtain best execution if it interposes a broker that does not make a market in the security when it could have avoided the unnecessary commission payments by dealing directly with market makers.[139]

   Directed Trades. An adviser is relieved of this obligation when a client directs the adviser to use a particular broker. An adviser may, however, be required to make additional disclosure to clients when it receives some benefit from the direction of the trade.[140]

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135 *In the Matter of Alfred C. Rizzo*, Investment Advisers Act Release No. 897 (Jan 11, 1984) (investment adviser lacked a reasonable basis for advice and could not rely on "incredible claims" of issuer); *In the Matter of Baskin Planning Consultants, Ltd*., Investment Advisers Act Release 1297 (Dec. 19, 1991) (adviser failed adequately to investigate recommendations to clients).

136 *In the Matter of Kidder Peabody & Co., Inc*., Investment Advisers Act Release No. 232 (Oct. 16, 1968). *See also* rule 206(3)-2(c) (acknowledging adviser's duty of best execution of client transactions).

137 This obligation is different from a broker-dealer's best execution obligation, which typically focuses on the price at which an order is executed and does not consider the broker's compensation, whereas an adviser's duty requires it to consider the total transaction cost to its client. The SEC has brought enforcement actions against advisers alleging failure to seek best execution. *See, e.g., In the Matter of Renberg Capital Management, Inc.*, Investment Advisers Act Release No. 2064 (Oct 1, 2002); *In the Matter of Portfolio Advisory Services, LLC*, Investment Advisers Act Release. No. 2038 (June 30, 2002).

138 *See Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters*, Exchange Act Release No. 23170 (Apr. 23, 1986) ("1986 Soft Dollar Release"). To fulfill this duty, an investment adviser should "periodically and systematically" evaluate the execution it is receiving for clients. *Id.* The scope of the duty evolves as changes occur in the market that give rise to improved execution, including opportunities to trade at more reasonable prices. *See, e.g., Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266, 270-271 (3d Cir. 1998). *See also, In the Matter of Jamison, Eaton & Wood, Inc.*, Investment Advisers Act Release No. 2129 (May 15, 2003); *In the Matter of Portfolio Advisory Services, LLC, supra* note 137.

139 *In the Matter of Delaware Management Company, Inc*., Securities Exchange Act Release No. 8128 (July 19, 1967).

140 *See In the Matter of Mark Bailey & Co*., Investment Advisers Act Release No. 1105 (Feb. 24, 1988) (adviser failed to disclose that it did not negotiate commissions on directed trades, and failed to disclose that the adviser would be in a better position to negotiate commissions in bunched transactions for non-directed trades, and violated anti-fraud provisions of Advisers Act); *Jamison, Eaton & Wood, Inc*., *supra* note 138.

Use of Brokerage Affiliate. The Act does not prohibit advisers from using an affiliated broker to execute client trades. However, use of an affiliate involves a conflict of interest that must be disclosed to client.[141] For example, use of an affiliated broker may give the adviser incentive to "churn" the account.

Soft Dollars. Section 28(e) of the Exchange Act provides a safe harbor from liability for breach of fiduciary duties when advisers purchase brokerage and research products and services with client commission dollars under specified circumstances. In July 2006, the SEC issued a revised interpretation as to the scope of the safe harbor.[142]

Under section 28(e), an adviser that exercises investment discretion may lawfully pay commissions to a broker at rates higher than those offered by other brokers, as long as the services provided to the adviser by the broker-dealer: (i) are limited to "research" or "brokerage;" (ii) constitute lawful and appropriate assistance to the adviser in the performance of its investment decision-making responsibilities, and (iii) the adviser determines in good faith that the commission payments are reasonable in light of the value of the brokerage and research services received.

a. *Research Services.* "Research" services generally include the furnishing of advice, analyses, or reports concerning securities, portfolio strategy and the performance of accounts, which means the research must reflect the expression of reasoning or knowledge relating to the statutory subject matter bearing on the investment decision-making of the adviser. The SEC does not believe that products or services with "inherently tangible or physical attributes" meet this test.

   (i) Products or services generally falling within the safe harbor include traditional research reports, market data, discussions with research analysts, meetings with corporate executives, software that provides analysis of securities, and publications (other than mass-marketed publications).

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141 *Folger Nolan Fleming Douglas Capital Management, Inc*., Investment Advisers Act Release No. 2639 (Aug. 23, 2007) (adviser entered into agreements with clients to direct trades to affiliated broker without disclosing commission rates were twice as high as non-directed trades). *See also* Investment Advisers Act Release 1092, *supra* note 3 (if an investment adviser recommends that a client effect transactions through its broker-dealer employer, the anti-fraud provisions of the Advisers Act require that the adviser make full disclosure of the nature and extent of all adverse interests, including the amount of any compensation the advisers will receive from its broker-dealer employer in connection such transactions); *Don P. Matheson*, SEC Staff No-Action Letter (Aug. 2, 1976) (investment advisers that are also broker-dealers or registered representatives have a duty to inform their investment advisory clients of their ability to seek executions of transactions recommended through other broker-dealers firms); *David P. Atkinson*, SEC Staff No-Action Letter (Aug. 1, 1977).

142 *Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934*, Exchange Act Release No. 34-54165 (July 18, 2006) ("2006 Soft Dollar Release"), *available at* http://www.sec.gov/rules/interp/2006/34-54165.pdf. The release superseded parts (but not all) of the 1986 Soft Dollar Release. In particular, the 2006 Soft Dollar Release does not replace Section IV of the 1986 Release, which discusses an investment adviser's disclosure obligations.

(ii) Products or services not within the safe harbor include computer hardware, telephone lines, peripherals; salaries, rent, travel, entertainment, and meals; software used for accounting, recordkeeping, client reporting, or other administrative functions; and marketing seminars and other marketing costs.

(iii) Where a product or service has uses both inside and outside the safe harbor, the SEC believes that an adviser should make a reasonable allocation of the cost of the product or service according to its use and keep adequate books and records concerning allocations so as to be able to make the required good faith showing.[143]

b. *Brokerage Services.* "Brokerage" generally includes activities related to effecting securities transactions and incidental functions. According to the SEC, brokerage begins when the order is transmitted to the broker-dealer and ends when funds or securities are delivered to the client account.[144]

c. *Commissions*. The SEC interprets the safe harbor of section 28(e) as being available for research obtained in relation to commissions on agency transactions, and certain riskless principal transactions.[145]

d. *Disclosure Obligations.* Advisers are required to disclose to clients any soft dollar arrangements, regardless of whether the arrangements fall within the section 28(e) safe harbor.[146] Failure to disclose the receipt of products or services purchased with client commission dollars may constitute a breach of fiduciary duties and/or violation of specific provisions of the Advisers Act and other federal laws.[147]

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143 *See id.*, at Section F, n. 148.

144 *Id.*

145 Exchange Act Release No. 45194 (Dec. 27, 2001) ("Release No. 45194"), *available at* http://www.sec.gov/rules/interp/interparchive/interparch2001.shtml. In Release No. 45194, the SEC concluded with respect to riskless principal transactions that "[t]he term 'commission' in Section 28(e) . . . include[s] a markup, markdown, commission equivalent or other fee paid by a managed account to a dealer for executing a transaction where the fee and transaction price are fully and separately disclosed on the confirmation and the transaction is reported under conditions that provide independent and objective verification of the transaction prices subject to self-regulatory oversight." The SEC staff had previously interpreted the safe harbor as being available only to agency transactions. *Letter to Charles Lerner, Esq., Director of Enforcement, Pension and Welfare Benefit Administration, U.S. Department of Labor, from Richard Ketchum, Director, Division of Market Regulation, SEC* (July 25, 1990).

146 Form ADV, the registration form for advisers, requires that advisers disclose soft dollar arrangements. *See* Form ADV, Part 1A, Item 8; Part 2A, Item 12A.1. *See also SEC Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds* (Sept. 22, 1998), *available at* http://www.sec.gov/news/studies/softdolr.htm.

147 *See, e.g., In the Matter of S Squared Technology Corporation*, Investment Advisers Act Release No. 1575 (Aug. 7, 1996) (adviser's failure to disclose its receipt of benefits in exchange for benefits received in exchange for direction of client brokerage violated section 206 of the Act); *In the Matter of Schultze Asset Management*, Investment Advisers Act Release No. 2633 (Aug. 15, 2007) (adviser

5. *Proxy Voting*. The SEC has stated that an adviser delegated authority to vote client proxies has a fiduciary duty to clients to vote the proxies in the best interest of its clients and cannot subrogate the client's interests to its own.[148]

B. Substantive Requirements

The Act contains other, more specific prohibitions designed to prevent fraud. In addition, the SEC has adopted several anti-fraud rules, which apply to advisers registered with the SEC.

1. *Client Transactions*

a. *Principal Transactions.* Section 206(3) of the Act prohibits an adviser, acting as principal for its own account, from knowingly selling any security to or purchasing any security from a client for its own account, without disclosing to the client in writing the capacity in which it (or an affiliate[149]) is acting and obtaining the client's consent before the completion of the transaction.[150] The SEC staff has stated that notification and consent must be obtained separately for each transaction, *i.e.,* a blanket consent for transactions is not sufficient.[151]

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misrepresented to clients that it would restrict its use of soft dollars to cover only those expenses covered by section 28(e) when it used them to pay for operating expenses).

148 *Proxy Voting by Investment Advisers*, Investment Advisers Act Release No. 2106 (Jan. 31, 2003), *available at* http://www.sec.gov/rules/final/ia-2106.htm. In this release, the SEC adopted rule 206(4)-6, which requires, among other things, each registered investment adviser that has voting authority over client securities to adopt and implement policies and procedures reasonably designed to ensure that client securities are voted in the best interest of clients. The SEC has instituted enforcement action against an adviser that failed to disclose to clients its conflicts before voting their shares in a hotly contested proxy fight. *In the Matter of Deutsche Asset Management, Inc.*, Investment Advisers Act Release No. 2160 (Aug. 19, 2003). *See also* Section VI. B. 6 of this outline.

149 The SEC has applied section 206(3) not only to principal transactions engaged in or effected by any adviser, but also when an adviser causes a client to enter into a principal transaction that is effected by a broker-dealer that controls, is controlled by, or is under common control with, the adviser. *Interpretation of Section 206(3) of the Investment Advisers Act of 1940*, Investment Advisers Act Release No. 1732 (July 17, 1998)("Release 1732"), at n.3, *available at* http://www.sec.gov/rules/interp/interparchive/interparch1998.shtml. The SEC has instituted enforcement actions when advisers have effected principal transactions through affiliates without complying with section 206(3), s*ee, e.g., In the Matter of Calamos Asset Management,* Investment Advisers Act Release No. 1589 (Sept. 30, 1996), including "riskless principal" transactions; *In the Matter of Rothschild Investment Corporation*, Investment Advisers Act Release No. 1714 (Apr. 13, 1998); *In the Matter of Concord Investment Co*., Investment Advisers Act Release No. 1585 (Sept. 27, 1996).

150 Section 206(3). The SEC interprets "completion of the transaction" to mean by settlement of the transaction. Release 1732, *supra* note 149, *available at* http://www.sec.gov/rules/interp/ia-1732.htm. But the SEC believes that, in order for post-execution, pre-settlement consent to comply with section 206(3), the adviser must provide both sufficient disclosure for a client to make an informed decision, and the opportunity for the client to withhold consent. *Id.* While the notice must be in writing, the SEC staff has stated that oral consent is sufficient under the Act. *Dillon, Reed & Co*., SEC Staff No-Action Letter (Aug. 6, 1975). The notice and consent provisions of section 206(3) do not apply if the adviser is giving only impersonal advisory services. Rule 206(3)-1.

151 *Opinion of Director of Trading and Exchange Division*, Investment Advisers Act Release No. 40 (Jan. 5, 1945). The SEC has instituted enforcement actions against investment advisers for violating section

Pooled Investment Vehicles. The SEC staff has stated that section 206(3) may apply to client transactions with a pooled investment vehicle in which the adviser or its personnel may have interests depending on the facts and circumstances, including the extent of the interests held by the adviser and its affiliates.[152] The SEC staff, however, believes that section 206(3) does not apply to a transaction between a client account and a pooled investment vehicle of which the investment adviser and/or its controlling persons, in the aggregate, own 25% or less.[153]

Statutory Exception. The restrictions on principal transactions do not apply to transactions by a client where the adviser (or an affiliate) is also a broker-dealer, but "is not acting as an investment adviser with respect to the trade," *e.g.*, it has not given the advice to buy or sell the security.[154]

Updated →

Rule 206(3)-3T. The SEC has adopted a temporary rule, set to expire on December 31, 2014, that permits advisers that are also registered with the SEC as broker-dealers to comply with section 206(3) by providing oral (instead of written) notice of principal transactions so long as certain conditions are met.[155] Specifically, rule 206(3)-3T permits an adviser, with respect to a non-discretionary advisory account, to comply with section 206(3) of the Act by, among other things:

(i) providing written prospective disclosure regarding the conflicts arising from principal trades;

(ii) obtaining written, revocable consent from the client prospectively authorizing the adviser to enter into principal transactions;

(iii) making certain disclosures either orally or in writing and

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206(3) when they entered into principal transactions with their clients using only prior blanket disclosures and consents. *See In the Matter of Stephens, Inc.*, Investment Advisers Act Release No. 1666 (Sept. 16, 1997); *In the Matter of Clariden Asset Management (New York) Inc*., Investment Advisers Act Release No. 1504 (July 10, 1995).

152 ABA Letter 2005, *supra* note 103 at II.A.1. The SEC has instituted enforcement actions based on claims of violations of section 206(3) against advisers and their principals when the advisers effected transactions between their advisory clients and accounts in which the principals of the advisers held significant ownership interests. *See In the Matter of SEC v. Beacon Hill Asset Management, LLC, et al.*, Litigation Release No. 18950 (Oct. 28, 2004); *In the Matter of Gintel Asset Management, et al.*, Investment Advisers Act Release No. 2079 (Nov. 8, 2002).

153 *Gardner Russo & Gardner*, SEC Staff No-Action Letter (June 7, 2006).

154 Section 206(3) provides that the section's "prohibitions…shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction."

155 Rule 206(3)-3T. *Temporary Rule Regarding Principal Trades with Certain Advisory Clients,* Investment Advisers Act Release No. 2653 (Sep. 24, 2007) (adopting rule 206(3)-3T), *available at* http://www.sec.gov/rules/final/2007/ia-2653.pdf; *Temporary Rule Regarding Principal Trades with Certain Advisory Clients*, Investment Advisers Act Release 3522 (Dec. 20, 2012) (extending expiration date to Dec. 31, 2014), *available at* http://www.sec.gov/rules/final/2012/ia-3522.pdf.

obtaining the client's consent before each principal transaction;

(iv) sending to the client confirmation statements disclosing the capacity in which the adviser has acted and disclosing that the adviser informed the client that it may act in a principal capacity and that the client authorized the transaction; and

(v) delivering to the client an annual report itemizing the principal transactions.

With certain limited exceptions (for non-convertible investment-grade debt securities underwritten by the adviser or a person who controls, is controlled by, or is under common control with the adviser (a "control person")), the rule generally is not available for principal trades of securities issued or underwritten by the investment adviser or a control person of the adviser.[156]

Fiduciary Obligations. Compliance with the disclosure and consent provisions of section 206(3) or rule 206(3)-3T alone does not satisfy an adviser's fiduciary obligations with respect to a principal trade. The SEC has expressed the view that section 206(3) must be read together with sections 206(1) and (2) of the Act to require that the adviser disclose additional facts necessary to alert the client to the adviser's potential conflict of interest in the principal trade.[157]

b. *Agency Cross Transactions*. Section 206(3) also prohibits an adviser from knowingly acting as broker for both its advisory client and the party on the other side of the transaction without obtaining its client's consent before each transaction.[158]

Rule 206(3)-2. The SEC has adopted a rule permitting these "agency cross-transactions" without transaction-by-transaction disclosure if, among other things:

(i) the client has executed a written blanket consent after receiving full disclosure of the conflicts involved, which must be renewed each year;

(ii) the adviser provides a written confirmation to the client before the completion of each transaction providing, among other

[156] The rule also requires that each account for which the adviser relies on the rule be a brokerage account subject to the Exchange Act, and the rules thereunder, and the rules of the self-regulatory organization(s) of which it is a member.

[157] Release 1732, *supra* note 149. *See also Rocky Mountain Financial Planning, Inc*., SEC Staff No-Action Letter (Feb. 24, 1983) ("While section 206(3) of the Investment Advisers Act of 1940 requires disclosure of such interest and the client's consent to enter into the transaction with knowledge of such interest, the adviser's fiduciary duties are not discharged merely by such disclosure and consent. The adviser must have a reasonable belief that the entry of the client into the transaction is in the client's interest.").

[158] Section 206(3). The SEC staff has expressed the view that the provisions of section 206(3) do not apply when the adviser/broker effects the trade without charging a commission or other fee. Release No. 1732, *supra* note 149.

things, the source and amount of any remuneration it received; and

(iii) the disclosure document and each confirmation conspicuously disclose that consent may be revoked at any time.[159]

c. *Cross-Trades.* Effecting cross-trades between clients (where a third-party broker is used) is not specifically addressed by the Act, but is subject to the anti-fraud provisions of the Act.[160] Cross-trades involve potential conflicts of interest (because the adviser could favor one client over another), and thus many advisers follow the methodology required by a rule under the Investment Company Act when one of the clients is an investment company.[161]

d. *Aggregation of Client Orders*. The SEC staff has stated that in directing orders for the purchase or sale of securities, an adviser may aggregate or "bunch" those orders on behalf of two or more of its accounts, so long as the bunching is done for the purpose of achieving best execution, and no client is systematically advantaged or disadvantaged by the bunching.[162]

Advisers that aggregate orders of securities face conflicts when they disaggregate the orders to client accounts since, for example, not all securities may have been acquired at the same price. Advisers should have procedures in place that are designed to ensure that the trades are allocated in such a manner that all clients are treated fairly and equitably.[163] For example, advisers can allocate orders based on a *pro rata*, rotational, or random basis.

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159 Rule 206(3)-2. The rule does not apply to a transaction when the adviser has discretionary authority to act for the purchaser and seller. Paragraph (c) of the rule admonishes advisers that the rule does not relieve them of the duty to act in the best interests of their clients, including the duty to obtain best price and execution for any transaction. *See Agency Cross Transactions for Advisory Clients*, Investment Advisers Act Release No. 589 (May 31, 1977) (adopting rule 206(3)-2).

160 *See* In *the Matter of Renberg Capital Management, Inc. and Daniel H. Renberg*, Investment Advisers Act Release No. 2064 (Oct. 1, 2002).

161 Rule 17a-7. Merely following the procedures set forth in rule 17a-7 may not satisfy an adviser's fiduciary obligations to clients. The staff has explained that it must be in the interest of both clients to enter into a cross trade and thus, for example, an adviser should not cause a client to enter into a cross-trade if it could obtain a better price in the markets. *Federated Municipal Funds*, SEC No-Action Letter (Nov. 20, 2006).

162 *Pretzel & Stouffer*, SEC Staff No-Action Letter (Dec. 1, 1995).

163 The SEC has instituted numerous enforcement actions against advisers that unfairly allocated client trades without making adequate disclosure. *See In the Matter of John McStay Investment Counsel, L.P*, Investment Advisers Act Release No. 2153 (July 31, 2003) (adviser failed to disclose change in its method of allocating initial public offerings among accounts to a method that favored mutual fund account); *In the Matter of McKenzie Walker Investment Management, Inc.*, *et al*., Investment Advisers Act Release No. 1571 (1996) (adviser allocated profitable trades to accounts charged a performance-based fee); *In the Matter of Nicholas-Applegate Capital Management*, Investment Advisers Act Release No. 1741 (Aug. 12, 1998) (adviser failed to supervise trader who allocated profitable trades to own personal account); *In the Matter of Ark Asset Management Co., Inc*., Investment Advisers Act Release No**.** 2962 (Dec. 14, 2009) (adviser allocated profitable trades to the proprietary hedge fund accounts at the expense of the client accounts without disclosing this practice).

2. *Advertising*. The anti-fraud provisions of the Act apply with respect to both clients and *prospective* clients. The SEC has adopted rule 206(4)-1, which prohibits any adviser registered with the SEC from using any advertisement that contains any untrue statement of material fact or is otherwise misleading.[164]

Specific Restrictions. An advertisement may not:

a. use or refer to testimonials, which staff views as including any statement of a client's experience with, or endorsement of, an adviser;[165]

b. refer to past specific recommendations made by the adviser, unless the advertisement sets out a list of all recommendations made by the adviser during the preceding year;

c. represents that any graph, chart, or formula can, in and of itself, be used to determine which securities to buy or sell; and

d. refer to any report, analysis, or service as free, unless it really is.

Performance Advertising. Advertisements containing information about the performance of client accounts must not be misleading. The SEC staff considers an advertisement containing performance information misleading if it implies, or if a reader would infer from it, something about an adviser's competence or possible future investment results that would be unwarranted if the reader knew all of the facts.[166] Advisers registered with the SEC must maintain records substantiating any performance claimed in an advertisement.[167]

Definition of Advertisement. While no communications to clients may be misleading, the specific restrictions discussed above apply only to "advertisements" by advisers, which the SEC defines generally as communications (in writing or electronic form) to more than one person that offer advisory services.[168] The SEC staff does not believe that a written

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164 Rule 206(4)-1. *See also SEC v. C.R. Richmond & Co*., 565 F.2d 1101, 1104 (9th Cir. 1977) (an adviser's advertising "must be measured from the viewpoint of a person unskilled and unsophisticated in investment matters"); *In the Matter of Jesse Rosenblum*, Investment Advisers Act Release No. 913 (May 17, 1984) (an investment adviser's advertisement that contained materially misleading statements was "not cured by the disclaimers buried in the [smaller print] text [of the advertisement]").

165 For further discussion, *see DALBAR, Inc.,* SEC Staff No-Action Letter (Mar. 24, 1997).

166 *Edward F. O'Keefe*, SEC Staff No-Action Letter (Apr. 13, 1978); *Anametrics Investment Management*, SEC Staff No-Action Letter (May 5, 1977). *See also Clover Capital Management, Inc.*, SEC Staff No-Action Letter (Oct. 28, 1986).

167 Rule 204-2(a)(16). *See In the Matter of Warwick Capital Management, Inc.*, Initial Decision Release No. 327 (Feb. 15, 2007). ("Respondent blamed a series of dubious calamities for their inability to produce records that would support the inflated numbers and created after-the-fact documents concerning the inflated numbers.").

168 Rule 206(4)-1(b) defines advertisement for purposes of the rule as "[a]ny notice circular, letter or other written communication addressed to more than one person, or any notice or other announcement in any publication or by radio or television, which offers (1) any analysis, report or publication concerning securities, or (2) any graph, chart, formula or other device to be used in making any determination as to

communication by an adviser that does no more than respond to an unsolicited request by a client is an advertisement even if it received multiple requests for the same information, *e.g.*, in multiple RFPs.[169]

Use of Social Media. Use of social media to communicate with clients and prospective clients may implicate rule 206(4)-1.[170]

3. *Custody of Client Assets*. A registered adviser with custody of client funds or securities ("client assets") is required by rule 206(4)-2 to take a number of steps designed to safeguard those client assets.[171] These requirements were amended in December 2009.[172]

    a. *Definition of Custody.* Custody means "holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them." An adviser has custody if an affiliate has custody of its client funds or securities in connection with advisory services it provides to clients.

    Custody includes:

    (i) Possession of client funds or securities;

    (ii) Any arrangement under which an adviser is permitted or authorized to withdraw client funds or securities (such as check-writing authority or the ability to deduct fees from client assets), and

    (iii) Any capacity that gives an adviser or its supervised person legal ownership of or access to client funds or securities (such as acting as general partner or trustee of a pooled investment vehicle).[173]

    b. *Qualified Custodians.* An adviser with custody must maintain client funds and securities with "qualified custodians" either under the client's name or under the adviser's name as agent or trustee for its clients. Qualified custodians are:

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when to buy or sell any security, or which security to buy or sell, or (3) any other investment advisory service with regard to securities." A communication covered by the rule may be made to new clients or to existing clients where the purpose is to induce them to renew their advisory contract or subscription. *Spear & Staff*, 42 S.E.C. 549 (1965).

169 *Investment Counsel Association of America*, SEC Staff Letter (Mar. 1, 2004).

170 The SEC staff has made observations regarding advisers' use of social media. *Investment Adviser Use of Social Media*, National Examination Risk Alert, Vol. II, Issue 1 (Jan. 4, 2012), *available at* http://www.sec.gov/about/offices/ocie/riskalert-socialmedia.pdf.

171 Rule 206(4)-2. The staff of the SEC's Division of Investment Management has published responses to "FAQs" (frequently asked questions) on the custody rule ("Custody Rule FAQs"), *available at* http://www.sec.gov/divisions/investment/custody_faq_030510.htm.

172 *See Custody of Funds or Securities of Clients by Investment Advisers*, Investment Advisers Act Release No. 2968 (Dec. 30, 2009) ("Release 2968"), *available at* http://www.sec.gov/rules/final/2009/ia-2968.pdf.

173 Rule 206(4)-2(d)(2).

(i) broker-dealers, banks, savings associations, futures commission merchants, and

(ii) non-U.S. financial institutions that customarily hold financial assets for their customers, if the institutions keep the advisory assets separate from their own.

c. *Quarterly Account Statements.* The adviser must have a reasonable basis, after due inquiry, for believing that the qualified custodian sends quarterly account statements directly to the client.[174]

d. *Notification*. The adviser must notify the client as to where and how the funds or securities will be maintained, promptly after opening an account for the client and following any changes to this information.[175] If the adviser also sends its own account statements to clients, this notice and subsequent account statements from the adviser must contain a statement urging the client to compare account statements from the custodian with those from the adviser.[176]

e. *Surprise Examinations.* An adviser that has custody of client assets generally must undergo an annual surprise examination by an independent public accountant to verify the client's funds and securities.[177] One exception from this requirement is if it has custody *solely* because it has authority to deduct advisory fees directly from client accounts.[178]

Updated → f. *Pooled Investment Vehicles.* If the adviser is the general partner of a limited partnership (or holds a similar position with another form of pooled investment vehicle such as a hedge fund)[179]:

(i) the adviser is deemed to have complied with the annual surprise examination requirement and need not form a reasonable belief regarding delivery of account statements if the pool's financial statements are audited by an independent public accountant that is registered with, and subject to regular inspection by, the Public

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174 A common method of forming a reasonable belief acceptable to the SEC is receipt of a copy of an account statement sent to the client. Release No. 2968, *supra* note 172.

175 Notice need not be given if the client opens the account himself.

176 Rule 206(4)-2(a)(2).

177 The timing of exams must be irregular from year to year. Rule 206(4)-2(a)(4). *See also, In the Matter of Kaufman, Bernstein, et al.*, Investment Advisers Act Release No. 2194 (Nov. 20, 2003) (independent auditor began examination the same date each year). The accountant conducting the examination must file a certificate on Form ADV-E within 120 days of the time chosen by the accountant for the examination. Rule 206(4)-2(a)(4)(i). The SEC has issued guidance for accountants performing an examination pursuant to this rule. *See Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940*, Investment Advisers Act Release No. 2969 (Dec. 30, 2009).

178 Rule 206(4)-2(b)(3).

179 The SEC staff takes the position that a state-created 529 plan may be treated as a pooled investment vehicle for these purposes. *See Investment Company Institute*, SEC Staff No-Action Letter (Sept. 5, 2012).

Company Accounting Oversight Board ("PCAOB"),[180] and the audited statements are distributed to the pool's investors;[181] or

(ii) the qualified custodian must send quarterly account statements to each investor in the pool and the adviser must obtain a surprise examination of the pool's assets.[182]

g. *Adviser or "Related Person" as Custodian.[183]* If the adviser or its related person maintains client assets as the qualified custodian in connection with the adviser's advisory services, the adviser must:

(i) have an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB perform the required annual surprise examination, unless the related person is "operationally independent" of the adviser;[184] and

(ii) obtain, or receive from the affiliate, an annual report of the internal controls relating to the custody of client assets prepared by an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB.[185]

4. *Use of Solicitors*. An adviser generally is prohibited by rule 206(4)-3 from paying a cash fee, directly or indirectly, to a third party (a "solicitor") unless it meets the requirements of the rule:

a. *Registered*. The adviser must be registered under the Act.

b. *Not Disqualified*. An adviser may not pay solicitation fees to a solicitor that would itself be subject to Statutory Disqualification as an investment adviser.[186]

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180 The audited financial statements must be prepared according to, or reconciled to, U.S. GAAP.

181 The audited financial statements must be distributed to investors within 120 days after the close of the pool's fiscal year. In 2006, the Division of Investment Management issued a letter indicating that it would not recommend enforcement action to the Commission under section 206(4) of the Act or rule 206(4)-2 against an adviser of a "fund of funds" relying on the annual audit provision of rule 206(4)-2 if the audited financial statements of the fund of funds are distributed to investors in the fund of funds within 180 days of the end of its fiscal year. *See ABA Committee on Private Investment Entities*, SEC Staff Letter (Aug. 10, 2006); Release 2968, *supra* note 172, at n. 45. *See also* Custody Rule FAQs, *supra* note 171.

182 Rule 206(4)-2(a)(5) and (a)(4).

183 A "related person" includes any person, directly or indirectly, controlling or controlled by the adviser, and any person that is under common control.

184 The surprise examination is not required of the adviser if it can demonstrate that the related person acting as qualified custodian is operationally independent. This determination is made by examining the relationship between the adviser and the related person, including whether there are common employees, shared premises, and common supervision. *See* rule 206(4)-2(d)(5).

185 Rule 206(4)-2(a)(6).

186 *See supra* notes 106-108 and accompanying text. Through a series of no-action letters, however, the SEC staff expressed the view that statutorily disqualified persons may act as solicitors if the disqualifying conduct is disclosed in a separate written document to be given to each solicited person (i) at least 48 hours before such solicited person enters into an advisory contract, or (ii) at the time the

c. *Written Agreement.* The solicitation fee must be paid pursuant to a written agreement that:

(i) describes the solicitation activities and the compensation to be paid;

(ii) contains an undertaking by the solicitor to perform his duties according to the agreement and in compliance with the Act; and

(iii) requires the solicitor to provide a prospective client a copy of:

(A) the adviser's disclosure statement (brochure), and

(B) a separate disclosure statement describing the terms of the solicitation arrangement, including that the solicitor is being compensated by the adviser.[187]

Solicitors. The rule defines a solicitor as anyone who, directly or indirectly, solicits any client for, or refers any client to, an investment adviser. The Commission believes that a solicitor would be a "person associated with an adviser" under the Act. The adviser has an obligation to supervise the activities of solicitors.[188]

Client Referrals. Rule 206(4)-3 does not apply to the direction of brokerage in return for client referrals. But the adviser directing brokerage to brokers referring clients to it has a significant conflict of interest. Accordingly, an adviser may be obligated to disclose to clients material information regarding conflicts arising from the arrangement, including any affect on the adviser's ability to obtain best execution.[189]

Pooled Investment Vehicles. The SEC staff has stated that the rule does not apply to payments by an adviser to solicit investments in a pooled investment vehicle sponsored by the adviser.[190]

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solicited person enters into the advisory contract, *if* the solicited person has the right to terminate the advisory contract within five days. Accordingly, the staff no longer issues no-action letters of this type, except if the facts raise novel or unusual circumstances. *See Dougherty & Company LLC*, SEC Staff No-Action Letter (July 3, 2003).

187 If the solicitor is an employee of the adviser, however, the solicitor is not required to provide prospective clients a copy of the adviser's brochure or the separate disclosure statement.

188 For discussion of an adviser's obligation to supervise cash solicitors acting on its behalf, *see Requirements Governing Payments of Cash Referral Fees by Investment Advisers*, Investment Advisers Act Release No. 615 (Feb. 2, 1978) (proposing release); *Requirements Governing Payments of Cash Referral Fees by Investment Advisers*, Investment Advisers Act Release No. 688 (July 12, 1979) (adopting release).

189 *In the Matter of Jamison, Eaton and Wood, Inc*., *supra* note 138; *In the Matter of Portfolio Advisory Services LLC, supra* note 137; *In the Matter of Founders Asset Management*, Investment Advisers Act Release No. 1953 (July 20, 2001); *In the Matter of Fleet Investment Advisers, Inc. (successor to Shawmut Investment Advisers, Inc.),* Investment Advisers Act Release No. 1821 (Sept. 9, 1999).

190 *Mayer Brown, LLP*, SEC Staff No-Action Letter (July 15, 2008). In its response, however, the staff noted that the solicitor may itself be an adviser subject to the antifraud provisions of the Act. The staff's response was amended on July 28, 2008 but indicates that the response letter should be deemed

5. *Pay to Play Rule*. On July 1, 2010, the Commission adopted rule 206(4)-5 to address so-called "pay to play" practices in which investment advisers make campaign contributions to elected officials of state or municipal governments in order to influence the award of contracts to manage public pension plan assets and other government investment accounts.[191] The rule applies to SEC-registered investment advisers, certain exempt reporting advisers, and foreign private advisers, who provide investment advisory services, or are seeking to provide investment advisory services, to state and municipal government entities.[192]

   a. *Prohibitions.* The rule contains three main prohibitions:

      (i) *Two-Year Time Out*. An investment adviser is prohibited from receiving compensation for providing advice to a government entity, either directly or through a “covered investment pool”, within two years after a contribution by the adviser, or by any of its “covered associates” (which include the adviser’s general partner or managing member, executive officers or other individuals with a similar status or function, solicitors, and political action committees they control) to an official of that government entity who can influence the award of advisory business.[193]

      (ii) *Third Party Solicitor Ban.* Neither an investment adviser nor any of its covered associates may provide or agree to provide, directly or indirectly, payment to any third party to solicit government clients for the adviser unless such person is a “regulated person.”[194]

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to have been issued on July 15. *See also* rule 206(4)-5 and Section VI. B. 5 of this outline regarding solicitation of government clients.

191 *Political Contributions by Certain Investment Advisers*, Investment Advisers Act Release No. 3043 (July 1, 2010)(“Pay to Play Release”), *available at* http://www.sec.gov/rules/final/2010/ia-3043.pdf. For staff responses to frequently asked questions about the rule, visit the SEC’s website at http://www.sec.gov/divisions/investment/pay-to-play-faq.htm.

192 Rule 206(4)-5(a).

193 Rule 206(4)-5(a)(1). An adviser subject to the rule is not prohibited from providing advisory services to a government client, even after triggering the two-year time out. Instead, an adviser is prohibited from receiving *compensation* for providing advisory services to such client during the time out. This enables an adviser to act consistently with its fiduciary obligations and provide uncompensated advisory services for a reasonable period of time to allow the government client to replace the adviser. *See also* Section VI. B. 4 regarding the cash solicitation rule that applies to all SEC-registered advisers.

194 Rule 206(4)-5(a)(2)(i). “Regulated persons” include (i) SEC-registered investment advisers that have not, and whose covered associates have not, within two years of soliciting a government entity, made a contribution to an official of that government entity; or bundled any contribution to an official or payment to a political party of a state or locality where the adviser is providing or seeking to provide investment advisory services to a government entity; (ii) registered broker-dealers that are subject to a pay to play rule adopted by the Financial Industry Regulatory Authority that the Commission, by order, finds substantially equivalent or more stringent than rule 206(4)-5; and (iii) a “municipal adviser” registered with the Commission and subject to rules adopted by the Municipal Securities Rulemaking Board that the Commission, by order, finds substantially equivalent or more stringent than rule 206(4)-

(iii) *Bundling Ban.* Rule 206(4)-5 prohibits an adviser and its covered associates from "bundling" others' contributions -- *i.e.* coordinating or soliciting any person or political action committee to make (A) any contribution to an official of a government entity to which the adviser is providing or seeking to provide investment advisory services; or (B) any payment to a political party of a state or locality where the investment adviser is providing or seeking to provide investment advisory services to a government entity.[195]

b. *Catch-All Provision.* Rule 206(4)-5(d) prohibits acts done indirectly, which, if done directly, would violate the rule.

c. *Covered Investment Pools.* Rule 206(4)-5 includes a provision that applies each of the prohibitions of the rule to an adviser that manages assets of a government entity through a "covered investment pool" defined as (i) any investment company registered under the Investment Company Act that is an investment option of a plan or program of a government entity;[196] or (ii) any company that would be an investment company under section 3(a) of the Investment Company Act but for the exclusions from that definition provided by section 3(c)(1), section 3(c)(7) or section 3(c)(11) of that Act.[197]

d. *Recordkeeping.* Rule 204-2 was amended to require registered advisers that provide investment advisory services to a government entity, or to a covered investment pool in which a government entity is an investor, to make and keep certain records related to the pay to play rule.

6. *Proxy Voting.* A registered adviser that exercises voting authority over client securities is required to vote them in the best interest of the client and not in its own interest. Rule 206(4)-6 requires advisers with voting authority over client securities to:

a. adopt and implement written policies and procedures that are reasonably designed to ensure that the adviser votes in the clients' best interests, and which must specifically address conflicts of interest that may arise between the adviser and its clients;

b. describe their voting policies and procedures to clients, deliver a copy of the policies and procedures to clients upon request, and inform clients how they can obtain information on how the adviser voted their securities; and

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5. This prohibition is limited to third-party solicitors. Thus, the prohibition does not apply to any of the adviser's employees, general partners, managing members, or executive.

195 Rule 206(4)-5(a)(2)(ii).

196 A plan or a program of a government entity includes participant-directed plans, such as college savings plans like 529 plans and retirement plans like 403(b) and 457 plans.

197 Rule 206(4)-5(f)(3).

c. keep certain records relating to voting of client securities.[198]

7. *Supervision.* An adviser has a continuing responsibility to supervise all persons acting on its behalf.[199] The SEC may sanction an adviser that "has failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision."[200]

   a. *Supervisor*. Whether a person has responsibility as a "supervisor" depends on whether, under the facts and circumstances of a particular case, the person has a requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue.[201]

   b. *Safe Harbor*. Under the Act, a person (*e.g*., an adviser or an officer of the adviser) will not be deemed to have failed to supervise a person if (i) the adviser had established procedures and a system for applying such procedures that are reasonably expected to prevent and detect the conduct, and (ii) the person reasonably discharged his supervisory duties and had no reasonable cause to believe that the procedures were not being complied with.[202]

8. *Compliance Program.* Under rule 206(4)-7 each registered adviser must establish an internal compliance program that addresses the adviser's performance of its fiduciary and substantive obligations under the Act.

   a. *Chief Compliance Officer*. Each adviser must designate a chief

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198 See also Section VI. A. 5 of this outline.

199 The SEC has stated that the "delicate fiduciary relationship" between an investment adviser and a client imposes an obligation on an adviser to review and to monitor its activities and the activities of its employees. *Shearson Lehman Brothers, Inc. and Stein Roe & Farnham*, Exchange Act Release No. 23640 (Sept. 24, 1986). The Commission has repeatedly emphasized that the duty to supervise is a critical component of the federal regulatory scheme. *See In re Rhumbline Advisers*, Investment Advisers Act Release. No. 1765 (Sept. 29, 1998); *In re Scudder Kemper Investments, Inc*., Investment Advisers Act Release. No. 1848 (Dec. 22, 1999) (adviser failed reasonably to supervise employee and did not have policies and procedures designed to detect and prevent employees' unauthorized trading in client accounts); *In re Nicholas-Applegate Capital Management*, Investment Advisers Act Release. No. 1741 (Aug. 12, 1998) (adviser failed reasonably to supervise employee and did not have policies and procedures designed to detect and prevent employees from engaging in improper personal trading); *In re Van Kampen American Capital Asset Management, Inc*., Investment Advisers Act Release. No. 1525 (Sep. 29, 1995) (adviser failed reasonably to supervise employee and did not have policies and procedures designed to detect and prevent employees from mispricing fund securities). Both registered and unregistered advisers have an obligation to supervise persons acting on their behalf. *In the Matter of Wilfred Mickel and Robert A. Littell*, Investment Advisers Act Release No. 2203 (Dec. 15, 2003). *See also In the Matter of Western Asset Management Co. and Legg Mason Fund Adviser, Inc*., Investment Advisers Act Release No. 1980 (Sept. 28, 2001) (adviser has a duty to supervise a sub-adviser); *TBA Financial Corporation*, SEC Staff No-Action Letter (Nov. 7, 1983) (duty to supervise employees who are also "registered representatives").

200 Section 203(e)(6).

201 *See In re John H. Gutfreund*, 51 S.E.C. 93, 113 (1992).

202 Section 203(e)(6).

compliance officer ("CCO").[203] The CCO must be knowledgeable about the Act and have the authority to develop and enforce appropriate compliance policies and procedures for the adviser. The CCO need not be an employee who does not have other duties.[204]

b. *Policies and Procedures.* Each adviser must also adopt and implement written policies and procedures reasonably designed to prevent the adviser or its personnel from violating the Act.[205] The SEC explained that each adviser, in designing its policies and procedures, should identify conflicts and other compliance factors creating risk exposure for the firm and its clients in light of the firm's particular operations, and then design policies and procedures that address those risks.[206] The SEC has stated that these policies and procedures should cover, at a minimum, the following areas to the extent applicable to the adviser:

(i) Portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with clients' investment objectives, disclosures by the adviser, and applicable regulatory restrictions;

(ii) Trading practices, including procedures by which the adviser satisfies its best execution obligation, uses client brokerage to obtain research and other services ("soft dollar arrangements"), and allocates aggregated trades among clients;

(iii) Proprietary trading of the adviser and personal trading activities of supervised persons;

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203 Rule 206(4)-7(c). The Commission has stated that having the title of chief compliance officer does not, in and of itself, carry supervisory responsibilities so that an adviser's chief compliance officer would not necessarily be subject to a sanction for failure to supervise other advisory personnel. Investment Advisers Act Release No. 2204 (Dec. 17, 2003) ("Release 2204") at n. 73 *available at* http://www.sec.gov/rules/final/finalarchive/finalarchive2003.shtml.

204 Release 2204, *supra* note 203 at Section II. C. However, the SEC recently settled an enforcement action alleging that a dually-registered broker-dealer and investment adviser violated section 206(4) of the Advisers Act and rule 206(4)-7 thereunder by failing to adopt and implement compliance policies and procedures specific to its advisory business when its CCO spent about 95% of his time on compliance-related issues for the firm's brokerage business and only about 5% of his time on compliance-related issues for the advisory business. *In the Matter of Feltl & Company, Inc.*, Investment Advisers Act Release No. 3325 (Nov. 28, 2011).

205 Rule 206(4)-7(a). The SEC has brought enforcement actions against advisers for failing to adopt and implement adequate policies and procedures as required by rule 206(4)-7. *See, e.g., In the Matter of OMNI Investment Advisors Inc. and Gary R. Beynon*, Investment Advisers Act Release No. 3323 (Nov. 28, 2011); *In the Matter of The Buckingham Research Group, Inc., Buckingham Capital Management, Inc., and Lloyd R. Karp*, Investment Advisers Act Release No. 3109 (Nov. 17, 2010); *In the Matter of Consulting Services Group, LLC, and Joe D. Meals*, Investment Advisers Act Release No. 2669 (Oct. 4, 2007).

206 The SEC has settled an enforcement action against an adviser that adopted a "pre-packaged" policies and procedures manual that failed to reflect the risk factors or conflicts of interest of the adviser; the SEC found that the adviser violated rule 206(4)-7 by failing to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act by that adviser's supervised persons. *In the Matter of Consulting Services Group, LLC, and Joe D. Meals*, *supra* note 205.

(iv) The accuracy of disclosures made to investors, clients, and regulators, including account statements and advertisements;

(v) Safeguarding of client assets from conversion or inappropriate use by advisory personnel;

(vi) The accurate creation of required records and their maintenance in a manner that secures them from unauthorized alteration or use and protects them from untimely destruction;

(vii) Marketing advisory services, including the use of solicitors;

(viii) Processes to value client holdings and assess fees based on those valuations;

(ix) Safeguards for the privacy protection of client records and information; and

(x) Business continuity plans.[207]

c. *Annual Review.* The adviser must review the adequacy and effectiveness of its policies at least annually.[208]

9. *Code of Ethics.* All advisers registered with the SEC must adopt and enforce a written code of ethics reflecting the adviser's fiduciary duties to its clients.[209] At a minimum, the adviser's code of ethics must:

a. *Standards of Conduct.* Set forth a minimum standard of conduct for all supervised persons;

b. *Compliance with Federal Securities Laws.* Require supervised persons to comply with federal securities laws;

c. *Personal Securities Transactions.* Require each of an adviser's access persons[210] to report his securities holdings at the time that the person becomes an access person and at least once annually thereafter and to make a report at least once quarterly of all personal securities transactions in reportable securities to the adviser's CCO or other designated person;[211]

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207 Release 2204, *supra* note 203.

208 Rule 206(4)-7(b).

209 Rule 204A-1. *See also, In the Matter of Consulting Services Group, LLC, and Joe D. Meals*, *supra* note 205 (adviser failed to timely adopt and accurately document ethics code).

210 Rule 204A-1(e)(1) defines "access person." Generally, an access person is a supervised person who has access to non-public information regarding clients' securities purchase or sale of securities.

211 Rule 204A-1(b) (1) (holdings reports), and (2) (transaction reports). Access persons do not have to report holdings of or transactions in: (i) direct obligations in of the U.S. government; (ii) certain bank instruments, commercial paper, and agreements; (iii) shares of money market funds; (iv) shares in open-end investment companies (mutual funds) that are not advised by either the adviser or an entity in a control relationship with the adviser); and (v) shares of a (US) unit investment trust that invests exclusively in an unaffiliated mutual fund. *See* rule 204A-1(j). *See also, M&G Investment*

d. *Pre-approval of Certain Securities Transactions.* Require the CCO or other designated persons to pre-approve investments by the access persons in IPOs or limited offerings;

e. *Reporting Violations.* Require all supervised persons to promptly report any violations of the code to the adviser's CCO or other designated person;

f. *Distribution and Acknowledgment.* Require the adviser to provide each supervised person with a copy of the code, and any amendments, and to obtain a written acknowledgment from each supervised person of his receipt of a copy of the code; and

g. *Recordkeeping.* Require the adviser to keep copies of the code, records of violations of the code and of any actions taken against violators of the code, and copies of each supervised person's acknowledgement of receipt of a copy of the code.

10. *Fraud Against Investors in Pooled Investment Vehicles*. Rule 206(4)-8 prohibits advisers from defrauding investors and prospective investors in pooled investment vehicles they advise.[212] The anti-fraud provisions of the Act (section 206(1) and (2)) prohibit advisers from defrauding "clients." A 2006 court decision created doubt about whether an investor in a pooled investment vehicle (*e.g.*, a hedge fund) advised by an adviser is a "client," and thus whether the SEC could enforce these provisions against an adviser that defrauds the investors, but not the fund.[213]

a. *Prohibition on False or Misleading Statements*. Rule 206(4)-8 prohibits advisers to pooled investment vehicles from making any materially false or misleading statements to investors or prospective investors in those pools.

b. *Prohibition of Other Frauds.* In addition, the rule prohibits advisers to pooled investment vehicles from otherwise defrauding the investors or prospective investors in those pools. This provision is designed to apply more broadly to fraudulent conduct that may not involve statements.

Management Ltd., SEC Staff No-Action Letter (Mar. 1, 2007) (permitting access persons of U.K.-based registered adviser to exclude from reports certain analogous instruments).

212 Rule 206(4)-8. *See Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles,* Investment Advisers Act Release No. 2628 (Aug. 3, 2007), *available at* http://www.sec.gov/rules/final/2007/ia-2628.pdf. *See also*, *SEC v. Rabinovich & Associates, LP, Alex Rabinovich and Joseph Lovaglio,* 07 Civ. 10547(GEL) (S.D.N.Y.) (Nov. 17, 2008); *SEC v. Moises Pacheco, et al.*, Civil Action No. 09-CV-1355-W-RBB (Nov. 19, 2009) (discussed in *In the Matter of Moises Pacheco,* Investment Advisers Act Release No. 2960 (Dec. 11, 2009)); *SEC v. Thomas J. Petters, et al,* Civil Action No. 09 SC 1750 ADM/JSM (D. Minn.) (Oct. 5, 2010) (discussed in *SEC v. Thomas J. Petters, et al,* Litigation Release No. 21687 (Oct. 18, 2010)); *SEC v. Donald Anthony Walker Young, et al,* Civil Action No. 09-1634 (E.D. Penn.)(Apr. 12, 2011); *SEC. v. Imperium Investment Advisors, LLC, et al,* 8:10-CV-02859-JDW-MAP (M.D.F.L) (June30, 2011) (discussed in *In the Matter of Imperium Investment Advisors, LLC*, Administrative Proceeding File No. 3-14471 (July 20, 2011)).

213 *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006).

c. *No Fiduciary Duty*. Rule 206(4)-8 does not create a fiduciary duty to investors or potential investors in a pooled investment vehicle not otherwise imposed by law, nor does it alter any duty or obligation an adviser has under the Advisers Act, or any state law or requirement to investors in a pooled vehicle.[214] In adopting the rule, the SEC explained that rule 206(4)-8 would, however, permit the SEC to enforce an adviser's fiduciary duty created by other law if the adviser fails to fulfill that duty by negligently or deliberately failing to make the required disclosure.

d. *Pooled Investment Vehicles.* Pooled investment vehicles include hedge funds, private equity funds, venture capital funds, and other types of privately offered pools that invest in securities as well as investment companies that are registered with the SEC under the Investment Company Act.[215]

11. *Insider Trading*. Section 204A of the Act requires advisers to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material, non-public information by the adviser or any of its associated persons,[216] including the misuse of material, non-public information about the adviser's securities recommendations and client securities holdings and transactions.[217]

12. *Brochure Rule*.

a. *Firm Brochure*. Rule 204-3, as amended in 2010, requires a registered adviser to prepare and deliver to clients a plain English, narrative brochure that contains all information required by Part 2A of Form ADV, including, among other things, the adviser's business practices, investment strategies, fees, conflicts of interest, and disciplinary information.[218] The adviser must deliver the brochure to a client before or at the time of entering into an advisory contract with the client, and must annually deliver to the client an updated brochure which contains or is accompanied by a summary of material changes, or a summary of

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214 An adviser to a hedge fund may have a separate relationship with an investor in a hedge fund that it advises that gives rise to fiduciary obligations. *U.S. v. Lay*, 566 F. Supp. 2d 652 (N.D. Ohio May 13, 2008).

215 Rule 206(4)-8(b) provides that a "pooled investment vehicle" means any investment company as defined in section 3(a) of the Investment Company Act or any company that would be an investment company under section 3(a) of that Act but for the exclusion provided from that definition by either Section 3(c)(1) or section 3(c)(7) of that Act.

216 The SEC has brought enforcement proceedings against advisers for violating section 204A. *See, e.g., In the Matter of Gabelli & Co. Inc*., Investment Advisers Act Release No. 1457 (Dec. 8, 1994).

217 *See also, Investment Adviser Code of Ethics*, Investment Advisers Act Release No. 2256 (July 2, 2004), *available at* http://www.sec.gov/rules/final/finalarchive/finalarchive2004.shtml ("We … remind advisers that they must maintain and enforce policies and procedures to prevent the misuse of material, non-public information, which we believe includes misuse of material, non-public information about the adviser's securities recommendations, and client securities holdings and transaction.").

218 As stated in Section V.B.2, the adviser must also file with the SEC the brochure that it delivered to its client to satisfy its registration requirements under rules 203-1 and 204-1.

material changes with an offer to deliver the updated brochure upon request. [219]

(i) *Non-Required Information.* Delivery of a brochure meeting the requirements of Part 2A does not necessarily satisfy an adviser's full disclosure obligation under the anti-fraud rules.[220] Accordingly, many advisers include additional information in their brochures.

(ii) *Exceptions to Delivery*. Advisers are not required to deliver a brochure to investment company clients or to clients for whom they provide only impersonal services for less than $500.[221]

(iii) *Electronic Delivery*. Advisers may deliver brochures electronically with client consent.[222]

b. *Brochure Supplement.* Rule 204-3 also requires the adviser to deliver a brochure supplement that contains information about an advisory employee, including the employee's educational background, business experience, other business activities, and disciplinary history, to a client before or at the time the employee begins to provide advisory services to that client.[223]

(i) *Covered employees*. An employee must deliver a brochure supplement to clients, if the employee formulates investment advice for the client and has direct client contact; or makes discretionary investment decisions for the client even if the employee has no direct client contact.[224]

(ii) *Exceptions to delivery.* Advisers are not required to deliver a brochure supplement to a client: (i) to whom the adviser is not required to deliver a brochure; (ii) who receives only impersonal service; or (iii) who is an officer, employee or other persons related to the adviser that would be "qualified client" under rule 205-3(d)(1).[225]

(iii) *Electronic Delivery*. Advisers may deliver brochure supplements

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219 Rule 204-3(b)(1) and (2).

220 *See* Part 2 Adopting Release, *supra* note 113, at n. 7.

221 Rule 204-3(c).

222 *Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information*, Investment Advisers Act Release No. 1562 (May 9, 1996) (publishing Commission interpretive guidance with respect to use of electronic media to fulfill investment advisers' disclosure delivery obligations).

223 Rule 204-3(b)(3).

224 *Id.* Note that if the investment advice is provided by a team comprised of more than 5 employees, only the 5 employees that have the most significant responsibility for the day-to-day advice to a client need to provide brochure supplements to that client. For more information, see Part 2 FAQs, *supra* note 113.

225 Rule 204-3(c)(2).

electronically with client consent.

13. *Systemic Risk Reporting on Form PF*. In October 2011, the SEC adopted rule 204(b)-1 requiring registered advisers with at least $150 million in private fund assets under management to submit regular reports on new Form PF. Advisers must file Form PF electronically on a confidential basis. Form PF is designed, among other things, to assist the Financial Stability Oversight Council in its assessment of systemic risk in the U.S. financial system.[226]

    a. *Smaller private fund advisers.* Advisers that manage at least $150 million of private fund assets, but less than the amounts that make them "large private fund advisers," complete only section 1 of Form PF. They file annually within 120 days of the end of their fiscal year.

       Section 1 requires, for each private fund, limited information about the size, leverage, investor types, investor concentration, liquidity and fund performance. This section also requires information regarding strategy, counterparty exposures, and use of trading and clearing mechanisms for each private fund that is a hedge fund.

    b. *Larger Private Funds Advisers.* Three types of "Large Private Fund Advisers" that meet certain thresholds for assets under management based on investment strategy type are required to complete additional sections of Form PF.[227]

        (i) *Large Hedge Fund Advisers.* Advisers managing at least $1.5 billion in hedge fund assets must file quarterly within 60 days of their quarter end and, in addition to Section 1, must complete Section 2 of Form PF.

            Section 2a requires information about aggregate hedge fund assets the adviser manages, such as the value of investments in different types of assets, the duration of fixed income holdings, the value of turnover for certain asset classes and the geographical breakdown of investments. Section 2b requires, for each hedge fund that has net assets of at least $500 million, more granular information about the fund's exposures, leverage, risk profile and liquidity.

        (ii) *Large Private Equity Fund Advisers.* Advisers managing at least $2 billion in private equity fund assets must file annually within 120 days of the end of their fiscal year (same as smaller advisers) and, in addition to Section 1, must complete section 4 of Form PF.

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226 *Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF*. Investment Advisers Act Release No. 3308 (Oct. 2011), *available at* http://www.sec.gov/rules/final/2011/ia-3308.pdf ("Form PF Adopting Release"). The staff of the Division of Investment Management has published responses to frequently asked questions on Form PF, *available at* http://www.sec.gov/divisions/investment/pfrd.pfrdfaq.shtml.

227 Form PF Adopting Release, *supra* note 226, at 21.

Section 4 requires information about the extent of leverage incurred by funds' portfolio companies, use of bridge financing, funds' investments in financial institutions, and geographical and industry breakdowns of funds' investments in portfolio companies.

(iii) *Large Liquidity Fund Advisers.* Advisers managing at least $1 billion in combined unregistered and registered money market fund assets must file quarterly within 15 days of their quarter end and, in addition to Section 1, must complete section 3 of Form PF

Item 3 requires information about each liquidity fund's portfolio, certain information relevant to the risk profile of the fund and the extent to which the fund has a policy of complying with all or aspects of rule 2a-7 under the Investment Company Act.

c. *Non-US. Advisers*. A registered adviser with a principal office and place of business outside the U.S. may omit reporting of any private fund that, during the preceding fiscal year: (i) was not organized in the U.S.; (ii) was not beneficially owned by one or more U.S. persons; and (iii) was not offered in the U.S.[228]

14. *Privacy Rules*. Title V of the Gramm-Leach-Bliley Act protects the privacy interests of consumers of financial services, including clients of SEC-registered investment advisers.[229] SEC rules implementing the statute protect only individuals' personal privacy interests, and not those of businesses or individuals who seek to obtain the services of an adviser for business purposes.[230]

a. *Notices*. An adviser must provide clients an *initial* and an *annual* notice of the adviser's privacy policies. The initial notice must be provided no later than when the client enters into an advisory contract.[231]

Content of Notice. Notices must be clear and conspicuous, *i.e.*, reasonably understandable and designed to call attention to the nature and significance of the notice. They must include, among other things: (i) categories of non-public personal information the adviser collects; (ii) categories of information the adviser shares; (iii) categories of

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228 General Instruction 1 (last paragraph) to Form PF.

229 Title V is not codified as part of the Advisers Act. It is codified at 15 U.S.C. 6801-6827.

230 *See* rule 248.3(g)(1). The SEC's implementing rules can be found at 17 CFR Part 248 ("Regulation S-P"). The rules apply to SEC-registered advisers. Rule 248.1(b). Advisers that are unregistered or are registered only with the states are subject to privacy regulations overseen by the Consumer Financial Products Board. Regulation S-P was adopted under the Securities Exchange Act, the Investment Company Act, and the Advisers Act; therefore the SEC has the remedies available under those statutes as applicable in enforcing the privacy rules. The SEC staff has posted responses to frequently asked questions about Regulation S-P at www.sec.gov/divisions/investment/guidance/regs2qa.htm.

231 Rules 248.4(a), 248.5(a).

affiliates and non-affiliates with which the adviser shares the information; and (iv) the adviser's policies and practices for protecting the confidentiality and security of information.

Model Form. The SEC has adopted a model form that advisers may choose to use to satisfy the initial and annual notice disclosure requirements. Use of the form provides advisers with a "safe harbor" for the content of the required notice under the privacy rules.[232]

b. *Opt-Out.* An adviser must provide clients with an opportunity to "opt out" or block the adviser from sharing "non-public" personal financial information with nonaffiliated third parties.[233]

Exceptions. An adviser does not have to provide an opt-out right in three circumstances:

(i) the information is provided to an affiliate;[234]

(ii) the adviser shares the information in the course of providing advisory services to the client (*e.g.*, with a broker, transfer agent, or lawyer) with the client's consent, or as required by law;[235] or

(iii) the adviser shares the information with a nonaffiliate that performs services, including marketing, for the adviser, but the adviser must have entered into a contract with the nonaffiliate that prohibits the nonaffiliate from using the information except for the purpose for which it received it.[236]

c. *Safeguarding and Properly Disposing of Client Information.*[237] An

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232 17 CFR 248.2, *adopted in, Final Model Privacy Form under the Gramm-Leach-Bliley Act*, Investment Advisers Act Release No. 2950 (Nov. 16, 2009), *available at* http://www.sec.gov/rules/final/2009/34-61003.pdf.

233 Rule 248.10.

234 Subpart B of Regulation S-P governs the use of certain information received by affiliates. This subpart, Regulation S-AM, allows a consumer, in certain limited situations, to block affiliates of advisers from soliciting the consumer, if the solicitation is derived from certain private information that the adviser has shared with an affiliate. Subpart B (Regulation S-AM) differs from Subpart A of Regulation S-P in that it does not restrict the *sharing* of certain information, only the actual *use* of the information to solicit. *See Regulation S-AM: Limitations on Affiliate Marketing*, Investment Advisers Act Release No. 2911 (August, 4, 2009) *available at* http://www.sec.gov/rules/final/2009/34-60423.pdf.

235 Rules 248.14, 248.15.

236 Rule 248.13.

237 The SEC has proposed additional amendments to its privacy rules. In 2012, the SEC proposed rules, including those that could require certain advisers who have custody or client assets or that otherwise qualify as financial institutions to (i) develop a program to identify "red flags" associated with identity theft, and (ii) have policies and procedure designed to prevent and mitigate identity theft in connection with its consumer accounts. *Identity Theft Red Flags Rules*, Investment Company Act Release No. 29969 (Feb. 28, 2012) *available at* http://www.sec.gov/rules/proposed/2012/ic-29969.pdf. In 2008, the SEC proposed amendments to its rules, including (i) a requirement that individuals be notified under certain circumstances in the event of a breach of security, (ii) additional guidance as to information that must be included in the safeguard and disposal polices, and (iii) a limited exception to the notice and opt-out requirements to allow a departing registered representative to take certain client

adviser must adopt written procedures reasonably designed to protect client records and information and to dispose of consumer report information properly.[238]

d. *"Non-public personal information"* includes "personally identifiable financial information" (a defined term) and any list, description, or other grouping of clients derived using "personally identifiable financial information" (*e.g.*, a client list):[239]

(i) "Personally identifiable financial information" includes information a client provides an adviser, information that results from services the adviser provides to the client, and information an adviser otherwise obtains about the client in connection with providing advisory services.[240]

(ii) "Non-public personal information" does not include "publicly available information"— *i.e.*, information the adviser reasonably believes is lawfully made available to the general public from government records, widely distributed media, or disclosures to the general public required by law.[241]

15. *Form 13F Disclosure*. An SEC-registered investment adviser that exercises investment discretion over at least $100 million in "section 13(f) securities" must periodically file Form 13F with the SEC.[242] This requirement was designed "to create a central depository of historical and current data about the investment activities of institutional investment managers" to assist investors and regulators.[243]

"Section 13(f) securities" generally include equity securities that trade on an exchange (including the NASDAQ National Market System).[244] Form 13F must be filed electronically, via the SEC's Electronic Data Gathering,

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information when leaving a firm. *Regulation S-P: Privacy of Consumer Financial Information and Safeguarding Personal Information,* Investment Advisers Act Release No. 2712 (Mar. 4, 2008).

238 Rule 248.30(a); 248.30(b). The SEC has settled an enforcement action against an investment adviser that failed to adopt procedures reasonably designed to protect client records and information. *See In the Matter of LPL Financial Corporation,* Investment Advisers Act Release No. 2775 (Sept. 11, 2008).

239 Rule 248.3(t)(1).

240 Rule 248.3(u)(1).

241 Rule 248.3(t)(2).

242 Section 13(f) of the Exchange Act; rule 13f-1(a) under the Exchange Act. *See In the Matter of Quattro Global Capital, LLC.*, Investment Advisers Act Release No. 2634 (Aug. 15, 2007) (adviser failed to File Form 13F); *In the Matter of Cabot Money Management Inc*., Investment Advisers Act Release No. 1577 (Aug. 15, 1996).

243 S. Rep. No. 94-75, 94th Cong., 2d Sess. 82-85 (1975). Each quarter, the SEC publishes a list of section 13(f) securities to assist institutional investment managers in the preparation of their Form 13F filings, *available at* http://www.sec.gov/divisions/investment/13flists.htm.

244 "Section 13(f) securities" also include certain equity options and warrants, shares of closed-end investment companies, and some convertible securities. Shares of open-end investment companies are not "section 13(f) securities." Rule 13f-1(c). The SEC publishes an official list of section 13(f) securities, *available at* http://www.sec.gov/divisions/investment/13flists.htm.

Analysis and Retrieval ("EDGAR") system, within 45 days after the end of the March, June, September, and December calendar quarters. Form 13F reports must identify, among other things: (i) the name of the issuer; (ii) the number of shares owned; and (iii) the fair market value, as of the end of the quarterly filing period, of the reported securities.[245]

Non-U.S. Advisers. Non-US investment advisers must file Form 13F if they (i) use any means or instrumentality of United States interstate commerce in the course of their business; and (ii) exercise investment discretion over $100 million or more in section 13(f) securities.[246]

16. *Large Trader Reporting*. An investment adviser that qualifies as a "large trader" must obtain a large trader identification number from the SEC, file and periodically update Form 13H, and disclose to each SEC-registered broker-dealer through which it trades its large trader identification number and all accounts to which that number applies.[247] These requirements were designed to assist the SEC in both identifying, and obtaining trading information on, market participants that conduct a substantial amount of trading activity.[248]

An adviser is a "large trader" if it exercises investment discretion over one or more accounts through which transactions in "national market system securities" are effected through one or more registered broker-dealers in amounts that, in the aggregate, amount to either: (i) 2 million shares or shares with a fair market value of $20 million during a calendar day; or (ii) 20 million shares or shares with a fair market value of $200 million during a calendar month.[249]

National market system securities. These securities include listed options and equity securities listed on an exchange (including the NASDAQ National Market System).[250] The scope of securities that fall under this definition is narrower than the scope of securities that trigger Form 13F filing.[251]

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245 The Division of Investment Management has published a "FAQ" regarding Form 13F ("13F FAQs"), *available at* http://www.sec.gov/divisions/investment/13ffaq.htm.

246 *See also* 13F FAQs *at* FAQ #4.

247 *See Large Trader Reporting*, Exchange Act Release No. 34-64976 (July 27, 2011) ("LTR Release"). The Commission adopted rule 13h-1 and related Form 13H, as directed by section 13(h) of the Exchange Act, on July 27, 2011. The rule also requires registered broker-dealers to monitor accounts for the purpose of identifying "unidentified large traders," capture certain information relating to all transactions on behalf of large traders and unidentified large traders that are effected directly or indirectly by or through them, and make such information available to the Commission through the already-established trade-reporting infrastructure, commonly referred to as the "electronic blue sheets." *See id*.

248 *Id.*

249 *See id.*

250 *See* Regulation NMS, rule 600(b)(46), (47) and (82).

251 *See supra* note 244 and accompanying text.

To comply, a large trader must file a Form 13H initial filing (via EDGAR) generally within 10 days after effecting aggregate transactions equal to or greater than the identifying activity level.[252] A large trader must then submit an annual filing within 45 days after the end of each calendar year, and must file an amendment no later than the end of the calendar quarter in which information became stale.[253]

Non-U.S. Advisers. Non-U.S. investment advisers that are "large traders under the rule" (*i.e.*, trade through SEC-registered broker-dealers) must comply with the rule's filing and disclosure requirements.[254]

C. Contractual Requirements

The Act does not require advisory contracts to be written[255] and the existence of a contract and the interpretation of its terms is generally a matter for state law. Section 205 of the Act, however, requires all advisory contracts to include certain provisions and prohibits the contracts from including other provisions entered into by advisers registered with, or required to be registered with, the SEC.

1. *Advisory Fees.* Advisers and clients are free to mutually agree to the amount of the adviser's compensation for its services, and the method by which it will be paid.[256]

   Performance Fees. With significant exceptions discussed below, section 205(a)(1) of the Act prohibits advisers from entering into a contract with a client that varies with the adviser's success in managing the client's money, *i.e.*, a fee based on a share of the capital gains or appreciation of a client's

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252 The form requires disclosure of, among other things, the large trader's contact information, its and its affiliates companies businesses, the forms it and its securities affiliates file with the Commission, its organizational structure and legal form, and a list of broker-dealers with which it maintains accounts. *See id.*

253 *See* LTR Release. A large trader may avoid updating filings if it obtains "inactive status" through a Form 13H filing by not having effected aggregated transactions in excess of the thresholds at any time during the previous full calendar year. *See id.*

254 Where the laws of a foreign jurisdiction prevent a non-U.S. large trader (whether itself a broker-dealer or adviser) from disclosing certain personal identifying information of an underlying principal, foreign large traders or representatives of foreign large traders may request an exemption from the SEC pursuant to section 36 of the Exchange Act and subsection (g) of rule 13h-1. *See id.*

255 However, section 15(a) of the Investment Company Act requires advisory contracts with investment companies to be in writing.

256 The SEC staff has taken the position that an investment adviser that charges fees which substantially exceed those charged by other investment advisers may violate section 206 of the Act, unless it discloses to existing and prospective clients that such a fee is higher than that charged by other advisers that provide the same or similar services. The staff had indicated that it will consider an advisory fee greater than 2% of the total assets under management as excessive and would violate section 206 unless the adviser disclosure is made that the fee is higher than that normally charged in the industry. *See Equitable Communications Co.,* SEC Staff No-Action Letter (Feb. 26, 1975); *Consultant Publications, Inc.*, SEC Staff No-Action Letter (Jan. 29, 1975); *Financial Counseling Corporation*, SEC Staff No-Action Letter (Dec. 7, 1974); *John G. Kinnard & Co.*, Inc., SEC Staff No-Action Letter (Nov. 30, 1973).

funds.[257] Congress included this provision in the Act because of its concern that a performance fee would encourage undue speculation with clients' investments.

a. *Assets Under Management.* The commonly charged fee based on an amount of assets under management is specifically excepted.[258]

b. *Fulcrum Fee.* The Act excepts from the performance fee prohibition a type of fee known as a "fulcrum fee." This is a fee for "big players" where the investment advisory contract involves registered investment companies or clients with over $1 million of assets.[259] The fee must be based on the asset value of the funds under management over a "specified period" and must increase or decrease proportionately with the "investment performance" of funds under management in relation to an "appropriate index of securities prices."[260]

c. *Non-U.S. Clients.* The Act also excepts contracts with persons who are not residents of the United States.[261] Congress added this exception in 1996 in recognition that the common use of performance fee arrangements in other countries placed U.S. advisers at a competitive disadvantage.

d. *Qualified Clients*. Rule 205-3 permits an adviser to enter into a performance fee contract with certain "qualified clients." A qualified client is a:

(i) natural person or company that has at least $1,000,000 under management with the adviser immediately after entering into the

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257 Section 205(a)(1). The SEC staff has taken the position that section 205(a)(1)'s prohibition of investment advisory contracts that contain performance fees extends to investment advisory contracts that provide for "contingent fees." *Contingent Advisory Compensation Arrangements*, Investment Advisers Act Release No. 721 (May 16, 1980). A contingent fee is "an advisory fee [that] will be waived or refunded, in whole or in part, if a client's account does not meet a specified level of performance" or that is contingent on the investment performance of the funds of advisory clients.

258 Section 205(b)(1).

259 Section 205(b)(2). The SEC has published a release discussing factors that investment companies considering entering into a fulcrum fee should consider. Investment Advisers Act Release No. 113 (Apr. 18, 1972).

260 Rules 205-1 and 205-2 define the terms in the text. *But see Royce Value Trust*, SEC Staff No-Action Letter (Dec. 22, 1986) (the SEC staff stated it would not object if an advisory agreement contained a performance fee that decreased at a greater rate than it increased and provided for no compensation if the net asset value per share declined). The SEC has instituted several enforcement cases against advisers who entered into advisory contracts with investment companies that charge performance fees that did not comply with section 205(b). In each case, the adviser charged the fund more that it could charge under section 205(b). *In the Matter of Gartmore Mutual Fund Capital Trust*, Investment Advisers Act Release No. 2548 (Sept. 7, 2006); *In the Matter of Putnam Investment Management*, LLC, Investment Advisers Act Release No. 2547 (Sept. 7, 2006); *In the Matter of Numeric Investors LLC*, Investment Advisers Act Release No. 2546. (Sept. 7, 2006); *In the Matter of Kensington Investment Group, Inc.*, Investment Advisers Act Release No. 2545 (Sept. 7, 2006).

261 Section 205(b)(5).

contract;[262]

(ii) natural person or company that the adviser reasonably believes has a net worth of more than $2 million at the time the contract is entered into,[263] or is a “qualified purchaser”;[264] or

(iii) natural person who is an officer, director, trustee, or general partner (or a person serving in a similar capacity) of the adviser, or an employee who participates in investment decisions of the adviser and has done so for at least 12 months.[265]

e. *Qualified Purchaser Funds*. The Act also excepts contracts with certain funds not registered under the Investment Company Act because they are offered only to certain wealthy or sophisticated investors.[266] The funds, which include many hedge funds, rely on the exception from the definition of “investment company” provided by section 3(c)(7) of the Investment Company Act.

f. *Other Funds.* Rule 205-3 excepts contracts with other types of funds, but only if *each* equity owner of the company is a qualified client with whom the adviser could otherwise enter into a performance fee contract under the rule.[267] This exception is available to (i) public investment companies registered under the Investment Company Act of 1940, (ii) business development companies, and (iii) private investment companies that rely on the exception provided by section

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262 Section 418 of Dodd-Frank Act directed the SEC to periodically adjust for inflation the dollar amount threshold for a “qualified client” every five years. In 2011, SEC issued an order to increase the minimum amount of assets under management threshold from $750,000 to $1,000,000. *See Order Approving Adjustment for Inflation of the Dollar Amount Tests in Rule 205-3 under the Investment Advisers Act of 1940*, Investment Advisers Act Release No. 3236 (July 12, 2011) (the “Performance Fee Order”). The SEC then amended rule 205-3 to codify the order in the rule. *See Investment Adviser Performance Compensation*, Investment Advisers Act Release No. 3372 (Feb. 15, 2012) (“Release 3372”).

263 The Performance Fee Order increased the dollar amount for the threshold from $1.5 million to $2 million. The SEC then amended rule 205-3 to codify the order in the rule and to exclude the value of a person’s primary residence and certain property-related debts from the test of whether a person has sufficient net worth to be considered a “qualified client.” *See* Release 3372, *supra* note 262.

264 A “qualified purchaser” is defined in the rule by reference to section 2(a)(51) of the Investment Company Act, which generally defines a "qualified purchaser" to include: (i) a natural person who owns not less than $5,000,000 in investments; (ii) a trust that meets certain requirements; and (iii) any person (including an investment adviser) who in the aggregate owns and invests on a discretionary basis not less than $25,000,000 in investments.

265 Rule 205-3(d)(1)(iii).

266 Section 205(b)(4).

267 For a discussion of some of the contours of this exception, *see Seligman New Technologies Fund II, Inc*., SEC Staff No-Action Letter (Feb. 7, 2002). The adviser itself and any equity owner not charged a performance fee need not be qualified clients. Rule 205-3(b). In an arrangement involving multiple tiers of funds, the analysis of whether a performance fee may be charged must be repeated at each tier. *Exception to Allow Registered Investment Advisers to Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client’s Account*, Investment Advisers Act Release No. 1731 (July 15, 1998).

3(c)(1) of the Investment Company Act.[268]

Non-U.S. Funds. The SEC staff has stated that if the fund is organized under the laws of a non-U.S. country, only the equity owners that are U.S. residents must be qualified clients.[269]

2. *Assignments of Advisory Contracts.* Advisory contracts must contain a provision prohibiting their assignment without consent of the client.[270] An assignment generally includes any direct or indirect transfer of an advisory contract by an adviser or any transfer of a controlling block of an adviser's outstanding voting securities.[271] A transaction that does not result in a change of actual control or management of the adviser (*e.g.*, a corporate reorganization) would not be deemed to be an assignment for these purposes.[272]

3. *Notification of Partnership Changes*. If the adviser is organized as a partnership, each of its advisory contracts must provide that the adviser will notify the client of a change in its membership.[273]

4. *Hedge Clauses*. The Act voids any provision of a contract that purports to waive compliance with any provision of the Act.[274] The SEC staff takes the position that an adviser that includes any such provision in a contract misleads its clients in violation of the Act's anti-fraud provisions by creating in the mind of the client the belief that a legal right or remedy under the Act is not available.[275]

   Indemnification Clauses. Historically, the SEC staff has taken the position that prohibition would, for example, preclude an adviser from purporting to limit its culpability to acts involving gross negligence or willful malfeasances,[276] even if the hedge clause explicitly provides that rights

[268] Rule 205-3(b) and (d)(3).

[269] *See Lazard Frères Asset Management*, SEC Staff No-Action Letter (Feb. 12, 1996).

[270] Section 205(a)(2).

[271] Section 202(a)(1).

[272] Rule 202(a)(1)-1. While rule 202(a)(1)-1 was adopted primarily to deal with intra-corporate reorganizations and reorganizations resulting from changes in domicile, the Division of Investment Management explained in a staff no-action letter that the rule is not so limited. *Zurich Insurance Company, Scudder Kemper Investments*, SEC Staff No-Action Letter (Aug. 31, 1998). Zurich involved a complex corporate transaction, the substance of which the Division did not address. Instead, the Division stated that the adviser must itself evaluate whether a particular transaction involves a change of actual control or management.

[273] Section 205(a)(3).

[274] Section 215(a).

[275] *Opinion of the General Counse*l, Investment Advisers Act Release No. 58 (Apr. 10, 1951). The SEC has instituted enforcement actions against advisers that have utilized hedge clauses in their advisory contracts. *In the Matter of William Lee Parks*, Investment Advisers Act Release No. 736 (Oct. 27, 1980); *In the Matter of Olympian Financial Services*, Inc. Investment Advisers Act Release No. 659 (Jan 16. 1979).

[276] *Auchincloss & Lawrence Inc*., SEC Staff No-Action Letter (Feb. 8, 1974).

under federal or state law cannot be relinquished.[277] More recently, the SEC staff has stated that whether such an indemnification clause would violate the Act's anti-fraud provisions, turns on "the form and content of the particular hedge clause (*e.g.*, its accuracy), any oral or written communications between the investment adviser and the client about the hedge clause, and the particular circumstances of the client."[278]

5. *Termination Penalties.* The SEC staff takes the position that certain fees that may have the effect of penalizing a client for ending the advisory relationship, or that may make the client reluctant to terminate an adviser, may be inconsistent with the adviser's fiduciary duties and may violate section 206.[279] Thus, the SEC staff interprets the anti-fraud provisions of the Act to require an adviser receiving its fee in advance to give a client terminating a contract a *pro rata* refund of pre-paid fees (less reasonable expenses),[280] unless the adviser is to receive a pre-determined amount upon termination for services already performed, and the client is provided adequate disclosure.[281]

D. <u>Recordkeeping Requirements</u>

The SEC generally requires a registered adviser to maintain two types of books and records: (i) typical accounting and other records that any business would normally keep; and (ii) certain additional records the SEC believes necessary in light of the adviser's fiduciary duties.[282]

The requirement to keep records does not turn on the medium in which a document is created or maintained. Thus, electronic documents, including e-mails, must be maintained if they meet the required record described below.

1. *Typical Records*

   a. All checkbooks, bank statements, and reconciliations.

   b. All written agreements entered into by the adviser with any client or otherwise relating to the business of the adviser, *e.g.,* rental and service agreements, mortgages, employment contracts, advisory contracts.

   c. All invoices or statements relating to the adviser's business.

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[277] *Omni Management Corp*. SEC Staff No-Action Letter (Dec. 13, 1975); *First National Bank of Akron*, SEC Staff No-Action Letter (Feb. 27. 1976).

[278] *Heitman Capital Management, LLC, et al.*, SEC Staff No-Action Letter (Feb. 12. 2007).

[279] *See, e.g., National Deferred Compensation*, SEC Staff No-Action Letter (Aug. 31, 1987) ("an adviser may not fulfill its fiduciary obligations if it imposes a fee structure penalizing a client for deciding to terminate the adviser's service or if it imposes an additional fee on a client for choosing to change his investment").

[280] *National Regulatory Services*, SEC Staff No-Action Letter (Dec. 2, 1992). The staff does not see this view altered by the decision *Transamerica v. Lewis*, 444 U.S. 11 (1979), that clients do not have a private right of action under section 206 of the Act, because they continue to have rights to sue for equitable damages under section 215 of the Act.

[281] *BISYS Fund Services, Inc.,* SEC Staff No-Action Letter (Sept. 2, 1999).

[282] Rule 204-2.

d. All cash receipts and disbursement journals, other journals, appropriate ledger accounts, all trial balances, financial statements, and internal audit working papers relating to the business of the adviser.

2. *Additional Records*

a. A record of the personal securities transactions of the adviser and its employees.

b. Copies of each report of personal securities holdings made by an access person under the adviser's code of ethics.

c. Documents supporting an adviser's decision to approve an access person's personal securities transactions.

d. A list of all persons who currently are "access persons" and who have been access persons within the last five years.

e. A memorandum of each order given by the adviser for the purchase or sale of any security and any instruction from the client concerning such purchase and sale.

f. A cross reference of securities held by client and by issuer.

g. All written communications received and copies of all written communications sent by the adviser relating to:

(i) any recommendation made or proposed to be made, and any advice given or proposed to be given;

(ii) any receipt, disbursement or delivery of funds or securities; or

(iii) the placing or executing of any order to purchase or sell any security.

h. Copies of all circulars, advertisements, newspaper articles, etc., sent to 10 or more persons.

i. A list of all accounts over which the adviser has discretionary authority.

j. Copies of any power of attorney.

k. A copy of each written statement given to any client in compliance with the brochure rule and any document prepared in compliance with the requirements of Form ADV.

l. Clients' acknowledgement of receipt of a solicitation agreement.

m. Documents substantiating any performance advertised.[283]

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[283] Rule 204-2(a)(16). *See* Investment Advisers Act Release No. 1135 (Aug. 17, 1988) (adopting paragraph (a)(16)); *see also Salomon Brothers Asset Management Inc. and Salomon Brothers Asset Management Asia Pacific Limited*, SEC Staff No-Action Letter (July 23, 1999) (explaining that records needed to be retained to substantiate performance). In addition, rule 204-2(e)(3)(ii) provides that advisers that had relied on the exemption from registration under section 203(b)(3) of the Act before

n. Certain additional records if the adviser has custody or possession of clients' cash or securities.[284]

o. Copies of the code of ethics and amendments thereto.

p. Records of violations of the code by supervised persons and of any actions taken against violators of the code of ethics.

q. Copies of each supervised person's written acknowledgment of receipt of a copy of the code of ethics.

r. Certain additional records regarding political contributions and advisory services to any government entity.[285]

3. *Other Requirements Regarding Recordkeeping*

a. All books and records required to be kept by the rule must be maintained and preserved in any easily accessible place for a period of no less than five years.[286]

b. Records required to be kept may be kept in micrographic media (*e.g.*, microfilm or microfiche) or in electronic storage media (*e.g.*, optical storage discs, CD ROMs).[287]

c. There are special recordkeeping rules for non-resident investment advisers.[288]

E. Applicability to Non-U.S. Advisers.

The SEC has stated that most of the requirements (discussed above) do not apply with respect to the non-U.S. clients of an SEC registered adviser whose principal place of business is not in the U.S.[289] For example, a non-U.S. adviser is not

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July 21, 2011 (the private adviser exemption) will not be subject to the requirement of maintaining records to support their calculation of the performance, or rate of return, of the accounts they managed or securities they recommended for any period prior to their registration with the SEC, provided that they continue to preserve any records in their possession that pertain to such performance or rate of return.

284 Rule 204-2(a)(17)(iii) and (b).

285 Rule 204-2(a)(18) and (h).

286 Rule 204-2(e). The first two years, the records must be kept in the offices of the adviser.

287 Rule 204-2(g). An adviser storing records in electronic storage media must establish and maintain procedures: (i) to preserve the records and safeguard them from loss, alteration or destruction; (ii) limit access to authorized personnel; and (iii) reasonably assure that any reproduction of paper records onto electronic media is accurate. *See In the Matter of Anthony Fields, CPA, et al.*, Investment Advisers Act Release No. 3348 (Jan. 4, 2012) (The SEC has instituted administrative proceedings alleging that adviser violated section 204 of the Advisers Act and rules 204-2(a)(11) and 204-2(e)(3)(i) thereunder by utilizing several email and online communication providers, each of which routinely deletes emails and online communications after six months, and doing nothing to retain these communications).

288 Rule 204-2(j).

289 *Registration Under the Advisers Act of Certain Hedge Fund Advisers*, Investment Advisers Act Release No. 2266 (July 20, 2004) at §II.C.(3)(c)(this rule was vacated by a federal court in 2006, *see supra* note 213). *See also* section 203(b)(3) of the Advisers Act amended by the Dodd-Frank Act,

required to maintain non-U.S. person client assets in accordance with the custody rule.

The SEC staff has stated that a non-U.S. adviser registered with the SEC is subject to examination by SEC staff and must maintain certain records with respect to all of its clients, including non-U.S. clients.[290]

F. Administrative Oversight

All records of a registered adviser (and not only those required to be created or maintained pursuant to SEC rule) are subject to examination by SEC staff.[291] Personnel in the SEC's Office of Compliance Inspections and Examinations located at SEC headquarters and various regional offices usually conduct inspections. All examinations are confidential.[292]

1. *Types of Inspections.* There are generally three types of inspections.

a. *Examinations of High-Risk Investment Advisers*. The SEC staff utilizes a risk-based process, identifying higher-risk investment advisers for examination consideration and focusing examination resources on certain higher-risk activities at selected investment advisers, including conflicts of interest, portfolio management, valuation, performance, advertising and asset verification. Typically, higher-risk investment advisers are identified based on (i) information contained in regulatory filings; (ii) assessments made during past examinations; and/or (iii) other criteria and available information.[293]

Release 3222, *supra* note 68 and Section III. B. 3 of this outline for discussion regarding foreign private adviser exemption.

290 The SEC staff has provided guidance in a series of no-action letters regarding the recordkeeping obligations of registered advisers that are located offshore. Under that analysis, the registered adviser must, in order to rely on the no-action relief, comply with the Act's recordkeeping rules, other than (i) rules 204-2(a)(3) and (7) with respect to transactions involving offshore clients that do not relate to advisory services performed by the registered adviser on behalf of United States clients or related securities transactions; and (ii) rules 204-2(a)(8), (9), (10), (11), (14), (15) and (16) and 204-2(b) with respect to transactions involving, or representations or disclosures made to, offshore clients. *See, e.g., Royal Bank of Canada,* SEC Staff No-Action Letter, (June 3, 1998). The Dodd-Frank Act added section 214(b) to the Advisers Act, which provides extraterritorial jurisdiction to U.S. federal courts regarding actions or proceedings brought by the Commission or the United States for violation of section 206 of the Act involving (i) conduct within the United States even if the violation is committed by a foreign adviser and involves only foreign investors; or (ii) conduct occurring outside the United States that has a foreseeable substantial effect within the United States.

291 *See* section 204 ("All records (as so defined) of such investment advisers are subject at any time, or from time to time, to such reasonable periodic, special, or other examinations." (emphasis added)).

292 Section 210(b) of the Act generally prohibits the SEC or the SEC staff from disclosing publicly either the existence of an examination or investigation conducted under the Act, or the results of or any facts ascertained during an examination or investigation.

293 *See Study on Enhancing Investment Adviser Examinations* (Jan. 19, 2011), *available at* http://sec.gov/news/studies/2011/914studyfinal.pdf (staff study required by section 914 of the Dodd-Frank Act, which directed the Commission to review and analyze the need for enhanced examination and enforcement resources for investment advisers); Commissioner Elisse B. Walter, *Statement on Study Enhancing Investment Adviser Examinations (Required by Section 914 of Title IV of the Dodd-*

b. *Special Purpose Reviews*. The SEC staff conducts risk-targeted examination sweeps regarding specific areas of concern within the financial services industry covering a broad sample of regulated entities regarding those areas. These sweeps are typically limited in scope. In addition, the SEC staff conducts limited scope examinations of an investment adviser's general business activities and a targeted set of the adviser's books and records to help OCIE better assess the risk profile of an investment adviser.[294]

c. *Cause Examinations.* These may be based on receipt of a complaint from a client or a competitor, press reports of problems, rumors, or anonymous tips.

In addition, OCIE launched a presence exams initiative in 2012 to conduct focused, risk-based examinations of investment advisers to private funds that registered with the Commission following the repeal of the private adviser exemption.[295] The presence exams include three phases: (i) an initial phase of industry outreach and education; (ii) followed by a coordinated series of examinations of a significant percentage of newly registered advisers focusing on the highest risk areas of their businesses; and (iii) culminating in the publication of a series of "after action" reports, reporting to the industry on the broad issues, risks and themes identified during the course of the examinations.[296]

2. *Focus of Inspections.* Examiners will generally focus on the various activities at an investment adviser deemed by the staff to be high risk. Among other things, the staff is seeking to detect violations of the federal securities laws, including the requirement that the adviser have effective compliance policies and procedures. When the SEC adopts new rules that are applicable to investment advisers, examiners may inquire about the areas affected by such rules and review relevant documentation to assess how the adviser is complying with the new requirements. Other examination focus areas are determined by the purpose for conducting the exam, business activities of the investment adviser, and the compliance controls surrounding those activities.[297]

3. *Results of Inspection.* Generally, there are three possible results from an examination.

   a. The SEC staff finds no problems and sends the adviser a letter stating that the inspection is finished (a rare event!).

Frank Wall Street Reform and Consumer Protection Act) (Jan. 19, 2011), *available at* http://sec.gov/news/speech/2011/spch011911ebw.pdf.

294 *Id.*

295 *See Letter to Newly Registered Investment Advisers from Drew Bowden, Deputy Director, Office of Compliance Inspections and Examinations, SEC* (Oct. 9, 2012), *available at* http://www.sec.gov/about/offices/ocie/letter-presence-exams.pdf.

296 *See* Norm Champ, "*What SEC Registration Means for Hedge Fund Advisers*" (May 11, 2012), *available at* http://sec.gov/news/speech/2012/spch051112nc.htm.

297 *See Study on Enhancing Investment Adviser Examinations, supra note* 293.

b. The SEC staff sends an “exam summary letter,” which informs the adviser of any violations or possible violations found and requests the adviser promptly to take any necessary corrective steps and submit a written response to the SEC staff of the corrective actions taken.

c. The SEC staff refers the inspection to the SEC’s Division of Enforcement for further consideration and possible commencement of an enforcement proceeding—not common as a first step.

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 275

Release No. IA-3222; File No. S7-37-10

RIN 3235-AK81

Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission (the "Commission") is adopting rules to implement new exemptions from the registration requirements of the Investment Advisers Act of 1940 for advisers to certain privately offered investment funds; these exemptions were enacted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). As required by Title IV of the Dodd-Frank Act – the Private Fund Investment Advisers Registration Act of 2010 – the new rules define "venture capital fund" and provide an exemption from registration for advisers with less than $150 million in private fund assets under management in the United States. The new rules also clarify the meaning of certain terms included in a new exemption from registration for "foreign private advisers."

DATES: Effective Date: July 21, 2011.

FOR FURTHER INFORMATION CONTACT: Brian McLaughlin Johnson, Tram N. Nguyen or David A. Vaughan, at (202) 551-6787 or <IArules@sec.gov>, Division of Investment Management, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-8549.

SUPPLEMENTARY INFORMATION: The Commission is adopting rules 203(l)-1, 203(m)-1 and 202(a)(30)-1 (17 CFR 275.203(l)-1, 275.203(m)-1 and 275.202(a)(30)-1) under the

Investment Advisers Act of 1940 (15 U.S.C. 80b) (the "Advisers Act").[1]

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I. BACKGROUND

On July 21, 2010, President Obama signed into law the Dodd-Frank Act,[2] which, among

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1 Unless otherwise noted, all references to rules under the Advisers Act will be to Title 17, Part 275 of the Code of Federal Regulations (17 CFR 275).

2 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

other things, repeals section 203(b)(3) of the Advisers Act.[3] Section 203(b)(3) exempted any investment adviser from registration if the investment adviser (i) had fewer than 15 clients in the preceding 12 months, (ii) did not hold itself out to the public as an investment adviser and (iii) did not act as an investment adviser to a registered investment company or a company that has elected to be a business development company (the "private adviser exemption").[4] Advisers specifically exempt under section 203(b) are not subject to reporting or recordkeeping provisions under the Advisers Act, and are not subject to examination by our staff.[5]

The primary purpose of Congress in repealing section 203(b)(3) was to require advisers to "private funds" to register under the Advisers Act.[6] Private funds include hedge funds, private equity funds and other types of pooled investment vehicles that are excluded from the definition of "investment company" under the Investment Company Act of 1940[7] ("Investment Company

[3] In this Release, when we refer to the "Advisers Act," we refer to the Advisers Act as in effect on July 21, 2011.

[4] 15 U.S.C. 80b-3(b)(3) as in effect before July 21, 2011.

[5] Under section 204(a) of the Advisers Act, the Commission has the authority to require an investment adviser to maintain records and provide reports, as well as the authority to examine such adviser's records, unless the adviser is "specifically exempted" from the requirement to register pursuant to section 203(b) of the Advisers Act. Investment advisers that are exempt from registration in reliance on other sections of the Advisers Act (such as sections 203(l) or 203(m) which we discuss below) are not "specifically exempted" from the requirement to register pursuant to section 203(b), and thus the Commission has authority under section 204(a) of the Advisers Act to require those advisers to maintain records and provide reports and has authority to examine such advisers' records.

[6] *See* S. Rep. No. 111-176, at 71-3 (2010) ("S. Rep. No. 111-176"); H. Rep. No. 111-517, at 866 (2010) ("H. Rep. No. 111-517"). H. Rep. No. 111-517 contains the conference report accompanying the version of H.R. 4173 that was debated in conference. While the Senate voted to exempt private equity fund advisers in addition to venture capital fund advisers from the requirement to register under the Advisers Act, the Dodd-Frank Act exempts only venture capital fund advisers. *Compare* Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong. § 408 (2010) (as passed by the Senate) *with* The Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. (2009) (as passed by the House) ("H.R. 4173") *and* Dodd-Frank Act (2010), *supra* note 2.

[7] 15 U.S.C. 80a.

Act") by reason of section 3(c)(1) or 3(c)(7) of such Act.[8] Section 3(c)(1) is available to a fund that does not publicly offer the securities it issues[9] and has 100 or fewer beneficial owners of its outstanding securities.[10] A fund relying on section 3(c)(7) cannot publicly offer the securities it issues[11] and generally must limit the owners of its outstanding securities to "qualified purchasers."[12]

Each private fund advised by an adviser has typically qualified as a single client for purposes of the private adviser exemption.[13] As a result, investment advisers could advise up to 14 private funds, regardless of the total number of investors investing in the funds or the amount

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8 Section 202(a)(29) of the Advisers Act defines the term "private fund" as "an issuer that would be an investment company, as defined in section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a-3), but for section 3(c)(1) or 3(c)(7) of that Act."

9 Interests in a private fund may be offered pursuant to an exemption from registration under the Securities Act of 1933 (15 U.S.C. 77) ("Securities Act"). Notwithstanding these exemptions, the persons who market interests in a private fund may be subject to the registration requirements of section 15(a) under the Securities Exchange Act of 1934 ("Exchange Act") (15 U.S.C. 78o(a)). The Exchange Act generally defines a "broker" as any person engaged in the business of effecting transactions in securities for the account of others. Section 3(a)(4)(A) of the Exchange Act (15 U.S.C. 78c(a)(4)(A)). *See also Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934*, Exchange Act Release No. 44291 (May 11, 2001) [66 FR 27759 (May 18, 2001)], at n.124 ("Solicitation is one of the most relevant factors in determining whether a person is effecting transactions.''); *Political Contributions by Certain Investment Advisers*, Investment Advisers Act Release No. 3043 (July 1, 2010) [75 FR 41018 (July 14, 2010)], n.326 ("Pay to Play Release").

10 *See* section 3(c)(1) of the Investment Company Act (providing an exclusion from the definition of "investment company" for any "issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities.").

11 *See supra* note 9.

12 *See* section 3(c)(7) of the Investment Company Act (providing an exclusion from the definition of "investment company" for any "issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of such securities."). The term "qualified purchaser" is defined in section 2(a)(51) of the Investment Company Act.

13 *See* rule 203(b)(3)-1(a)(2) as in effect before July 21, 2011.

of assets of the funds, without the need to register with us.[14]

In Title IV of the Dodd-Frank Act ("Title IV"), Congress generally extended Advisers Act registration to advisers to hedge funds and many other private funds by eliminating the private adviser exemption.[15] In addition to removing the broad exemption provided by section 203(b)(3), Congress amended the Advisers Act to create three more limited exemptions from registration under the Advisers Act.[16] These amendments become effective on July 21, 2011.[17] New section 203(l) of the Advisers Act provides that an investment adviser that solely advises venture capital funds is exempt from registration under the Advisers Act (the "venture capital exemption") and directs the Commission to define "venture capital fund" within one year of enactment.[18] New section 203(m) of the Advisers Act directs the Commission to provide an exemption from registration to any investment adviser that solely advises private funds if the

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[14] *See* Staff Report to the United States Securities and Exchange Commission, Implications of the Growth of Hedge Funds, at 21 (2003), http://www.sec.gov/news/studies/hedgefunds0903.pdf (discussing section 203(b)(3) of the Advisers Act as in effect before July 21, 2011). Concern about this lack of Commission oversight led us to adopt a rule in 2004 extending registration to hedge fund advisers. *See Registration Under the Advisers Act of Certain Hedge Fund Advisers*, Investment Advisers Act Release No. 2333 (Dec. 2, 2004) [69 FR 72054 (Dec. 10, 2004)] ("Hedge Fund Adviser Registration Release"). This rule was vacated by a federal court in 2006. *Goldstein v. Securities and Exchange Commission*, 451 F.3d 873 (D.C. Cir. 2006) ("Goldstein").

[15] Section 403 of the Dodd-Frank Act amended section 203(b)(3) of the Advisers Act by repealing the prior private adviser exemption and inserting a "foreign private adviser exemption." *See infra* Section II.C. Unlike our 2004 rule, which sought to apply only to advisers of "hedge funds," the Dodd-Frank Act requires that, unless another exemption applies, all advisers previously eligible for the private adviser exemption register with us regardless of the type of private funds or other clients the adviser has.

[16] Title IV also created exemptions and exclusions in addition to the three discussed at length in this Release. *See, e.g.*, sections 403 and 409 of the Dodd-Frank Act (exempting advisers to licensed small business investment companies from registration under the Advisers Act and excluding family offices from the definition of "investment adviser" under the Advisers Act). We are adopting a rule defining "family office" in a separate release (*Family Offices*, Investment Advisers Act Release No. 3220 (June 22, 2011)).

[17] Section 419 of the Dodd-Frank Act (specifying the effective date for Title IV).

[18] *See* section 407 of the Dodd-Frank Act (exempting advisers solely to "venture capital funds," as defined by the Commission).

adviser has assets under management in the United States of less than $150 million (the "private fund adviser exemption").[19] In this Release, we will refer to advisers that rely on the venture capital and private fund adviser exemptions as "exempt reporting advisers" because sections 203(l) and 203(m) provide that the Commission shall require such advisers to maintain such records and to submit such reports "as the Commission determines necessary or appropriate in the public interest or for the protection of investors."[20]

Section 203(b)(3) of the Advisers Act, as amended by the Dodd-Frank Act, provides an exemption for certain foreign private advisers (the "foreign private adviser exemption").[21] The term "foreign private adviser" is defined in new section 202(a)(30) of the Advisers Act as an investment adviser that has no place of business in the United States, has fewer than 15 clients in the United States and investors in the United States in private funds advised by the adviser,[22] and less than $25 million in aggregate assets under management from such clients and investors.[23]

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[19] *See* section 408 of the Dodd-Frank Act (directing the Commission to exempt private fund advisers with less than $150 million in aggregate assets under management in the United States).

[20] *See* sections 407 and 408 of the Dodd-Frank Act.

[21] Advisers specifically exempt under section 203(b) are not subject to reporting or recordkeeping provisions under the Advisers Act, and are not subject to examination by our staff. *See supra* note 5.

[22] Subparagraph (B) of section 202(a)(30) refers to the number of "clients and investors in the United States in private funds," while subparagraph (C) refers to the assets of "clients *in the United States* and investors in the United States in private funds" (emphasis added). We interpret these provisions consistently so that only clients *in the United States* and investors in the United States should be included for purposes of determining eligibility for the exemption under subparagraph (B).

[23] The exemption is not available to an adviser that "acts as — (I) an investment adviser to any investment company registered under the [Investment Company Act]; or (II) a company that has elected to be a business development company pursuant to section 54 of [that Act], and has not withdrawn its election." Section 202(a)(30)(D)(ii). We interpret subparagraph (II) to mean that the exemption is not available to an adviser *that advises* a business development company. This exemption also is not available to an adviser that holds itself out generally to the public in the United States as an investment adviser. Section 202(a)(30)(D)(i).

These new exemptions are not mandatory.[24] Thus, an adviser that qualifies for any of the exemptions could choose to register (or remain registered) with the Commission, subject to section 203A of the Advisers Act, which generally prohibits most advisers from registering with the Commission if they do not have at least $100 million in assets under management.[25]

On November 19, 2010, the Commission proposed three rules that would implement these exemptions.[26] First, we proposed rule 203(l)-1 to define the term "venture capital fund" for purposes of the venture capital exemption. Second, we proposed rule 203(m)-1 to implement the private fund adviser exemption. Third, in order to clarify the application of the foreign private adviser exemption, we proposed new rule 202(a)(30)-1 to define several terms included in the statutory definition of a foreign private adviser as defined in section 202(a)(30) of the Advisers Act.[27] On the same day, we also proposed rules to implement other amendments made to the

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24 An adviser choosing to avail itself of an exemption under section 203(l), 203(m) or 203(b)(3), however, may be required to register as an adviser with one or more state securities authorities. *See* section 203A(b)(1) of the Advisers Act (exempting from state regulatory requirements any adviser registered with the Commission or that is not registered because such person is excepted from the definition of an investment adviser under section 202(a)(11)). *See also infra* note 488 (discussing the application of section 222 of the Advisers Act).

25 Section 203A(a)(1) of the Advisers Act generally prohibits an investment adviser regulated by the state in which it maintains its principal office and place of business from registering with the Commission unless it has at least $25 million of assets under management. Section 203A(b) preempts certain state laws regulating advisers that are registered with the Commission. Section 410 of the Dodd-Frank Act amended section 203A(a) to also prohibit generally an investment adviser from registering with the Commission if the adviser has assets under management between $25 million and $100 million and the adviser is required to be registered with, and if registered, would be subject to examination by, the state security authority where it maintains its principal office and place of business. *See* section 203A(a)(2) of the Advisers Act. In each of subparagraphs (1) and (2) of section 203A(a), additional conditions also may apply. *See* Implementing Adopting Release, *infra* note 32, at section II.A.

26 *Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less than $150 Million in Assets under Management, and Foreign Private Advisers*, Investment Advisers Act Release No. 3111 (Nov. 19, 2010) [75 FR 77190 (Dec. 10, 2010)] ("Proposing Release").

27 Proposed rule 202(a)(30)-1 included definitions for the following terms: (i) "client;" (ii) "investor;" (iii) "in the United States;" (iv) "place of business;" and (v) "assets under management." *See* discussion in section II.C of the Proposing Release, *supra* note 26. We

Advisers Act by the Dodd-Frank Act, which included reporting requirements for exempt reporting advisers.[28]

We received over 115 comment letters in response to our proposals to implement the new exemptions.[29] Most of these letters were from venture capital advisers, other types of private fund advisers, and industry associations or law firms on behalf of private fund and foreign investment advisers.[30] We also received several letters from investors and investor groups.[31] Although commenters generally supported the various proposed rules, many suggested modifications designed to expand the breadth of the exemptions or to clarify the scope of one or more elements of the proposed rules. Commenters also sought interpretative guidance on certain aspects of the scope of each of the rule proposals and related issues.

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proposed rule 202(a)(30)-1, in part, pursuant to section 211(a) of the Advisers Act, which Congress amended to explicitly provide us with the authority to define technical, trade, and other terms used in the Advisers Act. *See* section 406 of the Dodd-Frank Act.

28 *Rules Implementing Amendments to the Investment Advisers Act of 1940*, Investment Advisers Act Release No. 3110 (Nov. 19, 2010) [75 FR 77052 (Dec. 10, 2010)] ("Implementing Proposing Release").

29 The comment letters on the Proposing Release (File No. S7-37-10) are available at: http://www.sec.gov/comments/s7-37-10/s73710.shtml. We also considered comments submitted in response to the Implementing Proposing Release that were germane to the rules adopted in this Release.

30 *See, e.g.,* Comment Letter of Biotechnical Industry Organization (Jan. 24, 2011) ("BIO Letter"); Comment Letter of Coalition of Private Investment Companies (Jan. 28, 2011) ("CPIC Letter"); Comment Letter of European Private Equity and Venture Capital Association (Jan. 24, 2011 ("EVCA Letter"); Comment Letter of O'Melveny & Myers LLP (Jan. 25, 2011) ("O'Melveny Letter"); Comment Letter of Norwest Venture Partners (Jan. 24, 2011) ("Norwest Letter").

31 *See, e.g.*, Comment Letter of the American Federation of Labor and Congress of Industrial Organizations (Jan. 24, 2011) ("AFL-CIO Letter"); Comment Letter of Americans for Financial Reform (Jan. 24, 2011) ("AFR Letter"); Comment Letter of The California Public Employees Retirement System (Feb. 10, 2011) ("CalPERS Letter"). *See also, e.g.,* Comment Letter of Adams Street Partners (Jan. 24, 2011); Comment Letter of Private Equity Investors, Inc. (Jan. 21, 2011) ("PEI Funds Letter") (letters from advisers of funds that invest in other venture capital and private equity funds).

II. DISCUSSION

Today, the Commission is adopting rules to implement the three new exemptions from registration under the Advisers Act. In response to comments, we have made several modifications to the proposals. In a separate companion release (the "Implementing Adopting Release") we are adopting rules to implement other amendments made to the Advisers Act by the Dodd-Frank Act, some of which also concern certain advisers that qualify for the exemptions discussed in this Release.[32]

A. Definition of Venture Capital Fund

We are adopting new rule 203(l)-1 to define "venture capital fund" for purposes of the new exemption for investment advisers that advise solely venture capital funds.[33] In summary, the rule defines a venture capital fund as a private fund that: (i) holds no more than 20 percent of the fund's capital commitments in non-qualifying investments (other than short-term holdings) ("qualifying investments" generally consist of equity securities of "qualifying portfolio companies" that are directly acquired by the fund, which we discuss below); (ii) does not borrow or otherwise incur leverage, other than limited short-term borrowing (excluding certain guarantees of qualifying portfolio company obligations by the fund); (iii) does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; (iv) represents itself as pursuing a venture capital strategy to its investors and prospective investors; and (v) is not registered under the Investment Company Act and has not elected to be treated as a business development company ("BDC").[34] Consistent with the proposal, rule

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32 *Rules Implementing Amendments to the Investment Advisers Act of 1940*, Investment Advisers Act Release No. 3221 (June 22, 2011).

33 Rule 203(l)-1.

34 Rule 203(l)-1(a).

203(l)-1 also "grandfathers" any pre-existing fund as a venture capital fund if it satisfies certain criteria under the grandfathering provision.[35] An adviser is eligible to rely on the venture capital exemption only if it solely advises venture capital funds that meet all of the elements of the definition or funds that have been grandfathered.

The proposed rule defined the term venture capital fund in accordance with what we believed Congress understood venture capital funds to be, as reflected in the legislative materials, including the testimony Congress received.[36] As we discussed in the Proposing Release, the proposed definition of venture capital fund was designed to distinguish venture capital funds from other types of private funds, such as hedge funds and private equity funds, and to address concerns expressed by Congress regarding the potential for systemic risk.[37]

We received over 70 comment letters on the proposed venture capital fund definition, most of which were from venture capital advisers or related industry groups.[38] A number of commenters supported the Commission's efforts to define a venture capital fund,[39] citing the "thoughtful" approach taken and the quality of the proposed rule.[40] Commenters representing

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35 Rule 203(l)-1(b).

36 *See* Proposing Release, *supra* note 26, at n.38 and accompanying and following text.

37 *See, e.g.*, Proposing Release, *supra* note 26, discussion at section II.A. and text accompanying nn.43, 60, 61, 82, 99, 136.

38 The National Venture Capital Association submitted a comment letter, dated January 13, 2011 ("NVCA Letter") on behalf of its members, and 27 other commenters expressed their support for the comments raised in the NVCA Letter.

39 *See* BIO Letter; Comment Letter of Charles River Ventures (Jan. 21, 2011) ("Charles River Letter"); NVCA Letter.

40 *See, e.g.*, Comment Letter of Abbott Capital Management, LLC (Jan. 24, 2011) ("Abbott Capital Letter"); Comment Letter of DLA Piper LLP (Jan. 24, 2011) ("DLA Piper VC Letter"); Comment Letter of InterWest General Partners (Jan. 21, 2011) ("InterWest Letter"); NVCA Letter; Comment Letter of Oak Investment Partners (Jan. 24, 2011) ("Oak Investment Letter"); Comment Letter of Pine Brook Road Advisors, LP (Jan. 24, 2011) ("Pine Brook Letter").

investors and investor groups and others generally supported the rule as proposed,[41] one of which stated that the proposed definition "succeeds in clearly defining those private funds that will be exempt."[42] Some of these commenters expressed support for a definition that is no broader than necessary in order to ensure that only advisers to "venture capital funds, and not other types of private funds, are able to avoid the new mandatory registration requirements."[43]

Generally, however, our proposal prompted vigorous debate among commenters on the scope of the definition. For example, a number of commenters wanted us to take a different approach from the proposal and supported two alternatives. Two commenters urged us to rely on the California definition of "venture capital operating company."[44] These commenters did not, however, address our concern, discussed in the Proposing Release, that the California definition includes many types of private equity and other private funds, and thus incorporation of this definition would not appear consistent with our understanding of the intended scope of section 203(l).[45] Our concern was acknowledged in a letter we received from the current Commissioner for the California Department of Corporations, stating that "we understand the [Commission] cannot adopt verbatim the California definition of [venture capital fund]. Congressional

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41 *See* AFR Letter; AFL-CIO Letter; EVCA Letter; Comment Letter of U.S. Senator Carl Levin (Jan. 25, 2011) ("Sen. Levin Letter").

42 AFL-CIO Letter.

43 Sen. Levin Letter. Although they did not object to the approach taken by the proposed rule, several commenters cautioned us against defining venture capital fund more broadly than necessary to preclude advisers to other types of private funds from qualifying under the venture capital exemption. *See* AFR Letter; CalPERS Letter; Sen. Levin Letter ("a variety of advisers or funds are likely to try to seek refuge from the registration requirement by urging an overbroad interpretation of the term 'venture capital fund' . . . It is important for the Commission to define the term narrowly to ensure that only venture capital funds, and not other types of private funds, are able to avoid the new mandatory registration requirement.").

44 Comment Letter of Lowenstein Sandler PC (Jan. 4, 2011) ("Lowenstein Letter"); Comment Letter of Keith Bishop (Jan. 17, 2011).

45 *See* Proposing Release, *supra* note 26, at n.72 and accompanying and preceding text.

directives require the [Commission] to exclude private equity funds, or any fund that pivots its investment strategy on the use of debt or leverage, from the definition of [venture capital fund]."[46] For these reasons and the other reasons cited in the Proposing Release, we are not modifying the proposal to rely on the California definition.[47]

Several other commenters favored defining a venture capital fund by reference to investments in "small" businesses or companies, although they disagreed on the factors that would deem a business or company to be "small."[48] As discussed in the Proposing Release, we considered defining a qualifying fund as a fund that invests in small companies, but noted the lack of consensus for defining such a term.[49] We also expressed the concern in the Proposing Release that defining a "small" company in a manner that imposes a single standardized metric such as net income, the number of employees, or another single factor test could ignore the complexities of doing business in different industries or regions. This could have the potential result that even a low threshold for a size metric could inadvertently restrict venture capital funds from funding otherwise promising young small companies.[50] For these reasons, we are not

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46 Comment Letter of Preston DuFauchard, Commissioner for the California Department of Corporations (Jan. 21, 2011) ("DuFauchard Letter") (further stating that "while regulators might have an interesting discussion on whether private equity funds contributed to the recent financial crisis, in light of the Congressional directives such a dialogue would be academic.").

47 *See* Proposing Release, *supra* note 26, at n.72 and accompanying and preceding text.

48 *See* Comment Letter of National Association of Small Business Investment Companies and Small Business Investor Alliance (Jan. 24, 2011) ("NASBIC/SBIA Letter") (supported a definition of "small" company by reference to the standards set forth in the Small Business Investment Act regulations). *But cf.* Lowenstein Letter; Comment Letter of Quaker BioVentures (Jan. 24, 2011) ("Quaker BioVentures Letter"); Comment Letter of Venrock (Jan. 23, 2011) ("Venrock Letter") (each of which supported a definition of small company based on the size of its public float). *See also* Comment Letter of Georg Merkl (Jan. 25, 2011) ("Merkl Letter") (referring to "young, negative EBITDA [earnings before interest, taxes, depreciation and amortization] companies").

49 *See* Proposing Release, *supra* note 26, at section II.A.1.a. and n.69 and accompanying and following text.

50 *See* Proposing Release, *supra* note 26, at n.69 and accompanying and preceding text.

persuaded that the tests for a "small" company suggested by commenters address these concerns.

Unlike the commenters who suggested these alternative approaches, most commenters representing venture capital advisers and related groups accepted the approach of the proposed rule, and many of them acknowledged that the proposed definition would generally encompass most venture capital investing activity that typically occurs.[51] Several, however, also expressed the concern that a venture capital fund may, on occasion, deviate from its typical investing pattern with the result that the fund could not satisfy all of the definitional criteria under the proposed rule with respect to each investment all of the time.[52] Others explained that an investment fund that seeks to satisfy the definition of a venture capital fund (a "qualifying fund") would desire flexibility to invest small amounts of fund capital in investments that would not meet the criteria under the proposed rule, such as shares of other venture capital funds,[53] non-convertible debt,[54] or publicly traded securities.[55] Both groups of commenters urged us to accommodate them by broadening the definition and modifying the proposed criteria.

Commenters wanted advisers seeking to be eligible for the venture capital exemption to

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[51] *See, e.g.*, Comment Letter of the Committee on Federal Regulation of Securities of the American Bar Association (Jan. 31, 2011) ("ABA Letter"); ATV Letter; BIO Letter; NVCA Letter; Comment Letter of Proskauer LLP (Jan. 23, 2011); Comment Letter of Union Square Ventures, LLC (Jan. 24, 2011) ("Union Square Letter").

[52] *See, e.g.*, Comment Letter of Advanced Technology Ventures (Jan. 24, 2011) ("ATV Letter"); BIO Letter; NVCA Letter; Comment Letter of Sevin Rosen Funds (Jan. 24, 2011) ("Sevin Rosen Letter"). One commenter argued that the rule "should not bar the occasional, but also quite ordinary, financial activities" of a venture capital fund. Charles River Letter.

[53] *See, e.g.*, Comment Letter of Dechert LLP (Jan. 24, 2011) ("Dechert General Letter"); Comment Letter of First Round Capital (Jan. 24, 2011) ("First Round Letter"); Sevin Rosen Letter.

[54] *See, e.g.*, Comment Letter of BioVentures Investors (Jan. 24, 2011) ("BioVentures Letter"); Charles River Letter; Comment Letter of Davis Polk & Wardwell LLP (Jan. 24, 2011) ("Davis Polk Letter"); Merkl Letter.

[55] *See, e.g.*, Comment Letter of Cardinal Partners (Jan. 24, 2011) ("Cardinal Letter"); Davis Polk Letter; Comment Letter of Gunderson Dettmer Stough Villeneuve Franklin & Hachigian (Jan. 24, 2011) ("Gunderson Dettmer Letter"); Merkl Letter.

have greater flexibility to operate and invest in portfolio companies and to accommodate existing (and potentially evolving) business practices that may vary from what commenters characterized as typical venture capital fund practice.[56] Some argued that a limited basket for such atypical investing activity could facilitate job creation and capital formation.[57] They were also concerned that the multiple detailed criteria of the proposed rule could result in "inadvertent" violations of the criteria under the rule.[58] Some expressed concern that a Commission rule defining a venture capital fund by reference to investing activity would have the result of reducing an adviser's investment discretion.[59]

We are sensitive to commenters' concerns that the definition not operate to foreclose investment funds from investment opportunities that would benefit investors but would not change the character of a venture capital fund.[60] On the other hand, we are troubled that the cumulative effect of revising the rule to reflect all of the modifications supported by commenters

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[56] *See, e.g.*, NVCA Letter; Comment Letter of Bessemer Venture Partners (Jan. 24, 2011) ("Bessemer Letter"); Oak Investment Letter. *See also supra* note 51.

[57] *See, e.g.*, NVCA Letter (stating that a low level of 15% would "allow innovation and job creation to flourish within the venture capital industry"); Sevin Rosen Letter (a 20% limit would be "flexible enough not to severely impair the operations of bona fide [venture capital funds], a critically important resource for American innovation and job creation").

[58] *See, e.g.*, NVCA Letter ("Because of the consequence (*i.e.*, federal registration) of having even one inadvertent, non-qualifying investment, allowance for unintended or insignificant deviations, or differences in interpretations, is appropriate."); Comment Letter of SV Life Sciences (Jan. 21, 2011) ("SV Life Sciences Letter") (the "lack of flexibility and ambiguity in certain definitions . . . could cause our firm or other venture firms to inadvertently hold non-qualifying investments"). *See also* ATV Letter.

[59] DuFauchard Letter ("Only the VC Fund advisers/managers are in a position to determine what best form 'down-round' financing should take. Whether that should be new capital, project finance, a bridge loan, or some other form of equity or debt, is neither a question for the regulators nor should it be a question of strict regulatory control."); ESP Letter ("There is no way a single regulation can determine what the appropriate level of leverage should be for every portfolio company."); Merkl Letter ("The Commission should not regulate from whom the [portfolio company] securities can be acquired or how the [company's] capital can be used.").

[60] *See, e.g.*, Oak Investment Letter; Sevin Rosen Letter.

could permit reliance on the exemption by advisers to other types of private funds and thus expand the exemption beyond what we believe was the intent of Congress.[61] A number of commenters argued that defining a venture capital fund by reference to multiple detailed criteria could result in "inadvertent" violations of the definitional criteria by a qualifying fund.[62] Another commenter acknowledged that providing *de minimis* carve-outs to the multiple criteria under the proposed rule could be "cumbersome,"[63] which could lead to the result, asserted by some commenters, that an overly prescriptive rule could invite further unintentional violations of the registration provisions of the Advisers Act.[64]

To balance these competing considerations, we are adopting an approach suggested by several commenters that defines a venture capital fund to include a fund that invests a portion of its capital in investments that would not otherwise satisfy all of the elements of the rule ("non-qualifying basket").[65] Defining a venture capital fund to include funds engaged in some amount of non-qualifying investment activity provides advisers to venture capital funds with greater

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61 For example, one commenter suggested that the definition of venture capital fund include a fund that incurs leverage of up to 20% of fund capital commitments without limit on duration and invests up to 20% of fund capital commitments in publicly traded securities and an additional 20% of fund capital commitments in non-conforming investments. Charles River Letter. Under these guidelines, it would be possible to structure a fund that borrows up to 20% of the fund's "capital commitments" to acquire highly leveraged derivatives and publicly traded debt securities. If the fund only calls 20% of its capital, fund indebtedness would equal 100% of fund assets, all of which would be in derivative instruments or publicly traded debt securities.

62 *See supra* note 58.

63 First Round Letter.

64 *See, e.g., generally* NVCA Letter. *See also* Merkl Letter.

65 *See, e.g.*, Abbott Capital Letter; ATV Letter; Bessemer Letter; BioVentures Letter; Cardinal Letter; Charles River Letter; Comment Letter of CompliGlobe Ltd. (Jan. 24, 2011) ("CompliGlobe Letter"); Davis Polk Letter; First Round Letter; NVCA Letter; Comment Letter of PTV Sciences (Jan. 24, 2011) ("PTV Sciences Letter"); Quaker BioVentures; Comment Letter of Santé Ventures (Jan. 24, 2011) ("Santé Ventures Letter"); Sevin Rosen Letter; SV Life Sciences; Comment Letter of U.S. Venture Partners (Jan. 24, 2011) ("USVP Letter"); Venrock Letter.

investment flexibility, while precluding an adviser relying on the exemption from altering the character of the fund's investments to such extent that the fund could no longer be viewed as a venture capital fund within the intended scope of the exemption. To the extent an adviser uses the basket to invest in some non-qualifying investments, it will have less room to invest in others, but the choice is left to the adviser. While the definition limits the amount of non-qualifying investments, it allows the adviser to choose how to allocate those investments. Thus, one venture capital fund may take advantage of some opportunities to invest in debt whereas others may seek limited opportunities in publicly offered securities. The definition of "business development company" under the Advisers Act contains a similar basket for non-qualifying investments.[66]

Commenters suggested non-qualifying baskets ranging from 15 to 30 percent of a fund's capital commitments, although many of these same commenters wanted us to expand the other criteria of the proposed rule.[67] Several commenters in favor of a non-qualifying basket asserted that setting the level for non-qualifying investments at a sufficiently low threshold would preclude advisers to other types of private funds from relying on the venture capital exemption while providing venture capital advisers the flexibility to take advantage of investment

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[66] Advisers Act section 202(a)(22) (defining a "business development company" as any company that meets the definition set forth in section 2(a)(48) of, and complies with section 55 of, the Investment Company Act, except that a BDC under the Advisers Act is defined to mean a company that invests 60% of its total assets in the assets specified in section 55 of the Investment Company Act).

[67] *See, e.g.*, NVCA Letter (more than 25 comment letters expressed general support for the comments raised in the NVCA Letter). Two commenters expressed support for a 30% basket for non-qualifying investments. *See* Comment Letter of Shearman & Sterling LLP (Jan. 24, 2011) ("Shearman Letter") (citing, in support of this position, the BDC definition under the Investment Company Act, which specifies a threshold of 30% for non-qualifying activity); Quaker BioVentures Letter (citing, in support of this position, the BDC definition under the Investment Company Act and the BDC definition under the Advisers Act which increased the non-qualifying activity threshold to 40%).

opportunities.[68] These commenters properly framed the question before us. We did not, however, receive specific empirical analysis regarding the venture capital industry as a whole that would help us determine the appropriate size of the basket.[69] Many of those supporting a 15 percent non-qualifying basket also supported expanding some of the other elements of the definition, and thus it is unclear whether a 15 percent non-qualifying basket alone would satisfy their needs.[70] On the other hand, those supporting a much larger basket did not, in our view, adequately address our concern that an overly expansive definition would provide room for advisers to private equity funds to remain unregistered, a consequence several commenters urged us to avoid.[71]

On balance, and after giving due consideration to the approaches suggested by commenters, we are adopting a limit of 20 percent of a qualifying fund's capital commitments for non-qualifying investments. We believe that a 20 percent limit will provide the flexibility sought by many venture capital fund commenters while appropriately limiting the scope of the

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68 Norwest Letter; Sevin Rosen Letter (noting that a 20% limit is "low enough to ensure that only true [venture capital funds] are able to qualify for the [venture capital] exemption."). *See also* NVCA Letter.

69 We did, however, receive much anecdotal evidence of particular advisers' experiences with non-qualifying investments. *See, e.g.*, Cardinal Letter ("In a very limited number of cases, it has been necessary for us to purchase securities from current shareholders of the portfolio company in order for the financing to be completed. However, in NO case have purchases from existing shareholders ever exceeded 15% of the total investment by Cardinal in a proposed financing."); Charles River Letter ("The vast majority of our investments are in the form of Convertible Preferred Stock. . . . However, very rarely - - but more often than never - - we invest in the form of a straight, non-convertible Demand Note."); Pine Brook Letter ("Our fund documents provide for investments outside of our core investing practice of up to 25% of our committed capital."). *But cf*. Mesirow Financial Private Equity Advisors, Inc. (Jan. 24, 2011) ("Mesirow Letter") (a Commission-registered adviser that advises funds that invest in other venture capital and private equity funds stated that "[s]ince the main purpose of [venture capital funds] is to invest in and help build operating companies, we believe their participation in non-qualifying activity will be rare.").

70 *See supra* note 67.

71 *See supra* note 43.

exemption. We note that several commenters recommended a non-qualifying basket limit of 20 percent.[72]

We considered adopting a 40 percent basket for non-qualifying investments by analogy to the Advisers Act definition of BDC.[73] That basket was established by Congress rather than the Commission, and it strikes us as too large in light of our task of implementing a statutory provision that does not specify a basket.[74] We find a better analogy in a rule we adopted in 2001 under the Investment Company Act. Under rule 35d-1 of that Act, commonly referred to as the "names rule," an investment company with a name suggesting that it invests in certain investments is limited to investing no more than 20 percent of its assets in other types of investments (*i.e.*, non-qualifying investments).[75] In adopting that rule, we explained that "if an investment company elects to use a name that suggests its investment policy, it is important that the level of required investments be high enough that the name will accurately reflect the

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72 *See, e.g.*, ATV Letter; Charles River Letter; Sevin Rosen Letter. At least one commenter stated that the minimum threshold limit for the non-qualifying basket should be 20%. Charles River Letter ("we believe anything less than 20% would be inadequate").

73 *See supra* note 66.

74 A larger non-qualifying basket of 40% could have the result of changing the fundamental underlying nature of the investments held by a qualifying fund, such as for example increasing the extent to which non-qualifying investments may contribute to the returns of the fund's portfolio.

75 Rule 35d-1(a)(2) under the Investment Company Act ("a materially deceptive and misleading name of a [registered investment company] includes . . . [a] name suggesting that the [registered investment company] focuses its investments in a particular type of investment or investments, or in a particular industry or group of industries, unless: (i) the [registered investment company] has adopted a policy to invest, under normal circumstances, at least 80% of the value of its [total assets] in the particular type of investments, or in investments in the particular industry or industries, suggested by the [registered investment company's] name . . ."). 17 CFR 270.35d-1(a)(2).

company's investment policy."[76] We noted that having a registered investment company hold a significant amount of investments consistent with its name is an important tool for investor protection,[77] but setting the limit at 20 percent gives the investment company management flexibility.[78] While our policy goal today in defining a "venture capital fund" is somewhat different from our goal in prescribing limitations on investment company names, the tensions we sought to reconcile are similar.[79]

1. Qualifying Investments

Under the rule, to meet the definition of venture capital fund, the fund must hold, immediately after the acquisition of any asset (other than qualifying investments or short-term holdings), no more than 20 percent of the fund's capital commitments in non-qualifying investments (other than short-term holdings).[80] Thus, as discussed above, a qualifying fund could invest without restriction up to 20 percent of the fund's capital commitments in non-

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[76] *Investment Company Names*, Investment Company Act Release No. 24828 (Jan. 17, 2001) [66 FR 8509, 8511 (Feb. 1, 2001), correction 66 FR 14828 (Mar. 14, 2001)] ("Names Rule Adopting Release").

[77] Names Rule Adopting Release, *supra* note 76, at text accompanying n.3 and text following n.7.

[78] *See* Names Rule Adopting Release, *supra* note 76, at text accompanying n.14. *See also* NVCA Letter; Sevin Rosen Letter (citing rule 35d-1 in support of recommending that the rule adopt a non-qualifying basket); Quaker BioVentures Letter (citing the approach taken by the staff generally limiting an investment company excluded by reason of section 3(c)(5)(C) of the Investment Company Act to investing no more than 20% of its assets in non-qualifying investments).

[79] A number of commenters recommended that the rule specify a range for the non-qualifying basket, arguing that this approach would provide advisers to venture capital funds with better flexibility to manage their investments over time. *See, e.g.*, DLA Piper VC Letter; DuFauchard Letter; Norwest Letter; Oak Investment Letter. As we discuss in greater detail below, the non-qualifying basket is determined as of the time immediately following each investment and hence a range is not necessary.

[80] Rule 203(l)-1(a)(2). The rule specifies that "immediately after the acquisition of any asset (other than qualifying investments or short-term holdings)" no more than 20% of the fund's aggregate capital contributions and uncalled committed capital may be held in assets (other than short-term holdings) that are not qualifying investments." *See infra* Section II.A.1.c. for a discussion on the operation of the 20% limit.

qualifying investments and would still fall within the venture capital fund definition.

For purposes of the rule, a "qualifying investment," which we discuss in greater detail below, generally consists of any equity security issued by a qualifying portfolio company that is directly acquired by a qualifying fund and certain equity securities exchanged for the directly acquired securities.[81]

a. Equity Securities of Portfolio Companies

Rule 203(l)-1 defines a venture capital fund as a private fund that, excluding investments in short-term holdings and non-qualifying investments, generally holds equity securities of qualifying portfolio companies.[82]

We proposed to define "equity security" by reference to the Exchange Act.[83] Commenters did not generally object to our proposal to do so, although many urged that we expand the definition of venture capital fund to include investments in other types of securities.[84] Commenters asserted that venture capital funds may invest in securities other than equity securities (including debt securities) for various business reasons, including to provide "bridge" financing to portfolio companies between equity financing rounds,[85] for working capital needs[86] or for tax or structuring reasons.[87] Many of these commenters recommended that the rule also

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81 *See* Sections II.A.1.b.

82 Rule 203(l)-1(a)(2) (specifying the investments of a venture capital fund); (c)(3) (defining "qualifying investment"); and (c)(6) (defining "short-term holdings").

83 Proposed rule 203(l)-1(c)(2).

84 Several commenters opposed any restriction on the definition of equity security. *See, e.g.,* Bessemer Letter; ESP Letter; NVCA Letter.

85 ATV Letter; NVCA Letter.

86 Comment Letter of Cook Children's Health Care Foundation Investment Committee (Jan. 20, 2011) ("Cook Children's Letter"); Comment Letter of Leland Fikes Foundation, Inc. (Jan. 21, 2011) ("Leland Fikes Letter").

87 Bessemer Letter; Merkl Letter.

define a venture capital fund to include funds that invest in non-convertible bridge loans of a portfolio company,[88] interests in other pooled investment funds (including other venture capital funds)[89] and publicly offered securities.[90] Commenters argued that these types of investments facilitate access to capital for a company's expansion,[91] offer qualifying funds flexibility to structure investments in a manner that is most appropriate for the fund (and its investors), including for example to obtain favorable tax treatment, manage risks (such as bankruptcy protection), maintain the value of the fund's equity investment or satisfy the specific financing needs of a portfolio company,[92] and enable a portfolio company to seek such financing from venture capital funds if the company is unable to obtain financing from traditional lending sources.[93]

We recognize that a venture capital fund may, on occasion, make investments other than in equity securities.[94] Under the rule, as discussed above, a venture capital fund may make these investments (as well as other types of investments that commenters may not have suggested) to

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88 *See, e.g.*, Comment Letter of CounselWorks LLC (Jan. 24, 2011); ESP Letter; Comment Letter of McGuireWoods LLP (Jan. 24, 2011) ("McGuireWoods Letter"); NVCA Letter; Oak Investment Letter. *See also* BioVentures Letter (supported venture capital fund investments in non-convertible debt without a time limit); Cook Children's Letter; Leland Fikes Letter (each of which expressed general support). One commenter indicated that the proposed condition limiting investments in portfolio companies to equity securities was too narrow. *See* Pine Brook Letter.

89 *See*, *e.g*., Cook Children's Letter; Leland Fikes Letter; PEI Funds Letter; Comment Letter of SVB Financial Group (Jan. 24, 2011) ("SVB Letter").

90 *See*, *e.g*., ATV Letter; BIO Letter (noted that investments by venture capital funds in "PIPEs" (*i.e*., "private investments in public equity") are "common").

91 *See*, *e.g*., Lowenstein Letter; Comment Letter of John G. McDonald (Jan. 21, 2011) ("McDonald Letter"); Quaker BioVentures Letter; Comment Letter of Trident Capital (Jan. 24, 2011) ("Trident Letter").

92 *See, e.g*., Merkl Letter; Oak Investments Letter; Sevin Rosen Letter; Comment Letter of Vedanta Capital, LP (Jan. 24, 2011) ("Vedanta Letter").

93 NVCA Letter; Trident Letter.

94 *See, e.g*., ESP Letter; Leland Fikes Letter; McGuireWoods Letter; NVCA Letter; Oak Investment Letter. *See also supra* Section II.A.

the extent there is room in the fund's non-qualifying basket. Hence, we are adopting the definition of equity security as proposed.

The final rule incorporates the definition of equity security in section 3(a)(11) of the Exchange Act and rule 3a11-1 thereunder.[95] Accordingly, equity security includes common stock as well as preferred stock, warrants and other securities convertible into common stock in addition to limited partnership interests.[96] Our definition of equity security is broad. The definition includes various securities in which venture capital funds typically invest and provides venture capital funds with flexibility to determine which equity securities in the portfolio company capital structure are appropriate for the fund. Our use of the definition of equity security under the Exchange Act acknowledges that venture capital funds typically invest in common stock and other equity instruments that may be convertible into equity common stock but does not otherwise specify the types of equity instruments that a venture capital fund could hold in deference to the business judgment of venture capital funds.

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95 Rule 203(l)-1(c)(2) (equity security "has the same meaning as in section 3(a)(11) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(11)) and § 240.3a11-1 of this chapter."). *See* 15 U.S.C. 78c(a)(11) (defining "equity security" as "any stock or similar security; or any security future on any such security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any other security which the Commission shall deem to be of similar nature and consider necessary or appropriate, by such rules and regulations as it may prescribe in the public interest or for the protection of investors, to treat as an equity security."); rule 3a11-1 under the Exchange Act (17 CFR 240.3a11-1) (defining "equity security" to include "any stock or similar security, certificate of interest or participation in any profit sharing agreement, preorganization certificate or subscription, transferable share, voting trust certificate or certificate of deposit for an equity security, limited partnership interest, interest in a joint venture, or certificate of interest in a business trust; any security future on any such security; or any security convertible, with or without consideration into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any put, call, straddle, or other option or privilege of buying such a security from or selling such a security to another without being bound to do so.").

96 *See* rule 3a11-1 under the Exchange Act (17 CFR 240.3a11-1) (defining "equity security" to include any "limited partnership interest").

b. Capital Used for Operating and Business Purposes

Rule 203(l)-1 defines a venture capital fund as a private fund that holds no more than 20 percent of the fund's capital commitments in non-qualifying investments (other than short-term holdings). Under the final rule, qualifying investments are generally equity securities that were acquired by the fund in one of three ways that suggest that the fund's capital is being used to finance the operations of businesses rather than for trading in secondary markets. As discussed in greater detail below, rule 203(l)-1 defines a "qualifying investment" as: (i) any equity security issued by a qualifying portfolio company that is directly acquired by the private fund from the company ("directly acquired equity"); (ii) any equity security issued by a qualifying portfolio company in exchange for directly acquired equity issued by the same qualifying portfolio company; and (iii) any equity security issued by a company of which a qualifying portfolio company is a majority-owned subsidiary, or a predecessor, and that is acquired by the fund in exchange for directly acquired equity.[97]

In the Proposing Release we explained that one of the features of venture capital funds that distinguish them from hedge funds and private equity funds is that they invest capital directly in portfolio companies for the purpose of funding the expansion and development of the companies' business rather than buying out existing security holders.[98] Thus, we proposed that, to meet the definition, at least 80 percent of a fund's investment in each portfolio company must be acquired directly from the company, in effect limiting a venture capital fund's ability to acquire secondary market shares to 20 percent of the fund's investment in each company.[99]

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97 Rule 203(l)-1(c)(3). A security received as a dividend by virtue of the fund's holding of a qualifying investment would also be a qualifying investment. *See generally infra* note 480.

98 Proposing Release, *supra* note 26, at text accompanying n.104.

99 Proposed rule 203(l)-1(a)(2).

A few commenters objected to any limitation on secondary market purchases of a qualifying portfolio company's shares,[100] but did not address the critical role this condition played in differentiating venture capital funds from other types of private funds, such as leveraged buyout funds, which acquire controlling equity interests in operating companies through the "buyout" of existing security holders.[101] Nor did they offer an alternative method in lieu of the direct acquisition criterion to distinguish venture capital funds from the buyout funds that are considered private equity funds. We continue to believe that the limit on secondary purchases is an important element for distinguishing advisers to venture capital funds from advisers to the types of private equity funds for which Congress did not provide an exemption.[102] Therefore, we are not modifying the definition of qualifying investment to broadly include equity securities acquired in secondary transactions.

We are, however, making two changes in this provision in response to commenters. First, we have eliminated the 20 percent limit for secondary market transactions that we included in this provision in our proposal in favor of the broader 20 percent limit for assets that are not qualifying investments.[103] Most commenters addressing the limit on secondary market acquisitions supported changing the threshold from 80 percent of the fund's investment in each portfolio company to either 50 percent in each portfolio company,[104] or 80 percent of the fund's

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[100] *See*, *e.g.*, ESP Letter; Merkl Letter.

[101] *See also* Proposing Release, *supra* note 26, at section II.A.1.d.

[102] *See id*., at n.112 and accompanying text.

[103] *Cf.* proposed rule 203(l)-1(a)(2) and rule 203(l)-1(a)(2).

[104] *See* DLA Piper VC Letter; Davis Polk Letter; Sevin Rosen Letter (each supported lowering the direct purchase requirement from 80% to 50% of each qualifying portfolio company's equity securities); Dechert General Letter (argued that the 20% allowance for secondary purchases should be increased to 45%, consistent with rules 3a-1 and 3c-5 under the Investment Company Act). *See also* ABA Letter (supported lowering the threshold from 80% to 70%); NVCA Letter; Mesirow Letter; Oak Investments Letter. Several commenters disagreed with the proposed direct

total capital commitments.[105] These commenters argued that secondary acquisitions provide liquidity to founders, angel investors and employees/former employees or align the interests of a fund with those of a portfolio company.[106]

We believe that the limit on secondary purchases remains an important element for distinguishing advisers to venture capital funds from advisers to the types of private equity funds for which Congress did not provide an exemption.[107] However, as discussed above, a venture capital fund may purchase shares in secondary markets to the extent it has room for such securities in its non-qualifying basket.

Second, the final rule defines qualifying investments as including equity securities issued by the qualifying portfolio company that are received in exchange for directly acquired equities issued by the same qualifying portfolio company.[108] This revision was suggested by a number of commenters to enable a qualifying fund to participate in the reorganization of the capital structure of a portfolio company, which may require the fund, along with other existing security holders, to accept newly issued equity securities in exchange for previously issued equity

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acquisition criterion and recommended that venture capital fund investments in portfolio company securities through secondary transactions should not be subject to any limit. *See, e.g.*, ESP Letter; Merkl Letter.

105 ATV Letter; Bessemer Letter; Charles River Letter; Davis Polk Letter; First Round Letter; Gunderson Dettmer Letter; InterWest Letter; Mesirow Letter; Norwest Letter; NVCA Letter; Oak Investment Letter; Sevin Rosen Letter; SVB Letter; Union Square Letter; Vedanta Letter. *See also* Comment Letter of Alta Partners (Jan. 24, 2011) ("Alta Partners Letter"); USVP Letter.

106 *See, e.g.*, Bessemer Letter; Norwest Letter; Sevin Rosen Letter.

107 *See* Proposing Release, *supra* note 26, at n.112 and accompanying text.

108 Under rule 203(l)-1(c)(3)(ii), "qualifying investments" include any equity security issued by a qualifying portfolio company in exchange for an equity security issued by the qualifying portfolio company that is directly acquired. *See infra* note 113.

securities.[109]

The rule similarly treats as a qualifying investment any equity security issued by another company in exchange for directly acquired equities of a qualifying portfolio company, provided that the qualifying portfolio company becomes a majority-owned subsidiary of the other company or is a predecessor company.[110] This provision enables a qualifying fund to acquire securities in connection with the acquisition (or merger) of a qualifying portfolio company by another company,[111] without jeopardizing the fund's ability to satisfy the definition of venture capital fund. A venture capital fund's acquisition of publicly offered securities in these circumstances may not present the same degree of interconnectedness with the public markets as secondary acquisitions through the open markets that are typical of other types of leveraged buyout private funds.[112] As a result of the modification to the proposed rule, a venture capital fund could hold equity securities of a company subject to reporting under the Exchange Act, if

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[109] *See, e.g.*, NVCA Letter. *See also* Sevin Rosen Letter. Although we understand that the securities received in an exchange are typically newly issued, the rule would also cover exchanges for outstanding securities. *See also infra* note 113.

[110] Under rule 203(l)-1(c)(3)(iii), "qualifying investments" include any equity security issued by a company of which a qualifying portfolio company is a majority-owned subsidiary (as defined in section 2(a)(24) of the Investment Company Act), or a predecessor company, and that is acquired by the private fund in exchange for an equity security described in paragraph (c)(3)(i) or (c)(3)(ii) of the rule. *See infra* note 113.

A "majority-owned subsidiary" is defined by reference to section 2(a)(24) of the Investment Company Act, (15 U.S.C. 80a2(a)(24), which defines a "majority-owned subsidiary" of any person as "a company 50 per centum or more of the outstanding voting securities of which are owned by such person, or by a company which, within the meaning of this paragraph, is a majority-owned subsidiary of such person."

[111] *See, e.g.,* Davis Polk Letter; Comment Letter of Institutional Venture Partners (Jan. 24, 2011) ("IVP Letter"); Mesirow Letter; PTV Sciences Letter. A number of commenters argued that without this expanded definition, typical transactions enabling a venture capital fund to restructure its investment in a portfolio company, exit its investment or obtain liquidity for itself and its investors, as well as profits, would be precluded. *See, e.g.*, NVCA Letter; PTV Sciences Letter.

[112] *See, e.g.*, Davis Polk Letter. *See also* Mesirow Letter.

such equity securities were issued to the fund in exchange for directly acquired equities of a qualifying portfolio company that became a majority-owned subsidiary of the reporting company.[113]

c. Operation of the 20 Percent Limit

Under the rule, to meet the definition of venture capital fund, a qualifying fund must hold, immediately after the acquisition of any asset (other than qualifying investments or short-term holdings), no more than 20 percent of the fund's capital commitments in non-qualifying investments (other than short-term holdings).[114] Under this approach, a fund need only calculate the 20 percent limit when the fund acquires a non-qualifying investment (other than short-term holdings); after the acquisition, the fund need not dispose of a non-qualifying investment simply because of a change in the value of that investment. A qualifying fund, however, could not purchase additional non-qualifying investments until the value of its then-existing non-qualifying investments fell below 20 percent of the fund's committed capital.

As discussed above, most commenters supporting a basket for non-qualifying investments recommended a limit expressed as a percentage of fund capital commitments.[115] One commenter further suggested that the value of investments included in the non-qualifying basket be calculated at the time each investment is made to include only those non-qualifying investments that are then held by the fund (thus excluding liquidated assets); the commenter

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113 Under the rule, a qualifying fund could separately purchase additional securities pursuant to a public offering (or recapitalization) from a company after it ceases to be a "qualifying portfolio company" (because for example such company has become a reporting or foreign traded company), subject to the non-qualifying basket.

114 Rule 203(l)-1(a)(2). The calculation of the 20% limit operates in a fashion similar to the diversification and "Second Tier Security" tests of rule 2a-7 under the Investment Company Act. 17 CFR 270.2a-7(a)(24). *See Revisions to Rules Regulating Money Market Funds*, Investment Company Act Release No. 18005 (Feb. 20, 1991) [56 FR 8113, 8118 (Feb. 27, 1991)].

115 *See supra* note 67.

argued that this approach would give funds certainty that a qualifying investment would not become "non-qualifying" and simplify the test for compliance.[116]

We are persuaded that the non-qualifying basket should be based on a qualifying fund's total capital commitments, and the fund's compliance with the 20 percent limit should be calculated at the time any non-qualifying investment is made, based on the non-qualifying investments then held in the fund's portfolio.[117] We understand that using a fund's capital commitments for determining investment thresholds is generally consistent with existing venture capital fund practice,[118] and nearly all of the commenters requesting a basket specified the basket as a percentage of the fund's capital commitments.[119] We expect that calculating the size of the non-qualifying basket as a percentage of a qualifying fund's capital commitments, which will remain relatively constant during the fund's term, will provide advisers with a degree of predictability when managing the fund's portfolio and determining how much of the basket remains available for new investments.

We acknowledge that limiting non-qualifying investments to a percentage of fund capital commitments could result in a qualifying fund that invests its initial capital call in non-qualifying

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116 Sevin Rosen Letter. *See also* BioVentures Letter (endorsing the NVCA Letter supporting a non-qualifying basket determined as a percentage of fund capital commitments, but also arguing in favor of determining the basket "at any point in time, rather than in the aggregate over the life of the fund").

117 Capital commitments that have been called but returned to investors and subject to a future call would be treated as uncalled capital commitments. Capital commitments that are no longer subject to a call by the fund would not be treated as uncalled capital commitments.

118 See *generally infra* notes 240-243 (discussing the use of a qualifying fund's capital commitments to determine the fund's compliance with the leverage criterion). *See also* DLA Piper VC Letter.

119 *See generally supra* note 67. For purposes of reporting its "regulatory assets under management" on Form ADV, an adviser would include uncalled capital commitments of a private fund advised by the adviser.

investments;[120] but that ability would be constrained by the adviser's need to reconcile that investment with the fund's required representation that it pursues a venture capital strategy.[121] An investment adviser that manages a fund in such a manner that renders the representation to investors and potential investors that the fund pursues a venture capital strategy an untrue statement of material fact would violate the antifraud provisions of the Advisers Act.[122] We understand that a venture capital fund is not typically required to call or fully draw down all of its capital commitments. However, only *bona fide* capital commitments may be included in the calculation under rule 203(l)-1.[123] For example, commitments made for the purpose of increasing the non-qualifying basket and with an understanding with investors that they will not be called cannot be included.[124]

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120 *See* AFL-CIO Letter; AFR Letter (discussing issues associated with specifying leverage as a percentage of fund capital commitments).

121 *See infra* Section II.A.7.

122 The Commission does not need to demonstrate that an adviser violating rule 206(4)-8 acted with *scienter*. *See Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles*, Investment Advisers Act Release No. 2628 (Aug. 3, 2007) [72 FR 44756 (Aug. 9, 2007)] ("Pooled Vehicles Release").

123 *See also Investment Adviser Performance Compensation*, Investment Advisers Act Release No. 3198 (May 10, 2011) [76 FR 27959 (May 13, 2011)] at n.17 (in determining whether a person holds the requisite amount of assets under management, an investment adviser may include "assets that a client is contractually obligated to invest in private funds managed by the adviser. Only *bona fide* contractual commitments may be included, *i.e*., those that the adviser has a reasonable belief that the investor will be able to meet.").

124 Similarly, fee waivers or reductions for the purpose of inducing investors to increase the size of their capital commitments with an understanding that they will not be called (and hence enable the adviser to increase the size of the non-qualifying basket) would indicate that the commitments are not *bona fide*. In addition, the amount of capital commitments and contributions made by investors and the investments made by the fund are indispensable to the functioning of a venture capital fund, and we understand advisers to venture capital funds typically maintain records reflecting them. *See generally supra* note 5 (describing the Commission's authority to examine the records of advisers relying on the venture capital exemption). We note that a person claiming an exemption under the federal securities laws has the burden of proving it is entitled to the exemption. *See, e.g., SEC v. Ralston Purina Co*., 346 U.S. 119, 126 (1953); *Gilligan, Will & Co. v. SEC,* 267 F.2d 461, 466 (2d Cir. 1959); *Swenson v. Engelstad*, 626 F.2d 421, 425 (5th Cir. 1980); *SEC v. Wall St. Transcript Corp*., 454 F. Supp. 559, 566 (S.D.N.Y. 1978) (stating that the

Moreover, we believe that by applying the 20 percent limit as of the time of acquisition of each non-qualifying investment, a fund is able to determine prospectively how much it can invest in the non-qualifying basket. We believe that this simpler approach to determining the non-qualifying basket would better limit a qualifying fund's non-qualifying investments and ease the burden of determining compliance with the criterion under the rule.

To determine compliance with the 20 percent limit, a venture capital fund would, immediately after the acquisition of any non-qualifying investment, excluding any short-term holdings,[125] calculate the total value of all of the fund's assets held at that time, excluding short-term holdings, that are invested in non-qualifying investments, as a percentage of the fund's total capital commitments.[126] For this purpose, the 20 percent test is determined based on the qualifying fund's non-qualifying investments after taking into account the acquisition of any newly acquired non-qualifying investment.[127]

To determine if a fund satisfies the 20 percent limit for non-qualifying investments, the fund may use either historical cost or fair value, as long as the same method is applied to all investments of a qualifying fund in a consistent manner during the term of the fund.[128] Under the rule, a venture capital fund could use either historical cost or fair value, depending, for example,

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defendant publisher "must register unless it can be shown that it is" entitled to rely on an exclusion from the definition of "investment adviser").

125 Rule 203(l)-1(c)(6) ("Short-term holdings" means cash and cash equivalents as defined in § 270.2a51-1(b)(7)(i), U.S. Treasuries with a remaining maturity of 60 days or less, and shares of an open-end management investment company registered under section 8 of the Investment Company Act of 1940 [15 U.S.C. 80a-8] that is regulated as a money market fund under § 270.2a-7 of this chapter.").

126 A qualifying investment that is acquired as a result of an exchange of equity securities provided by rule 203(l)-1(c)(3)(ii) and (iii) would not result in a requirement to calculate the 20% limit under rule 203(l)-1(a)(2).

127 Rule 203(l)-1(a)(2).

128 *Id*.

on the fund's approach to valuing investments since the fund's inception. Under the final rule, a qualifying fund using historical cost need not account for changes in the value of its portfolio due to, for example, market fluctuations in the value of a non-qualifying investment or the sale or other disposition of a qualifying investment (including the associated distribution of sale proceeds to fund investors). Requiring fair value in this particular instance could make investment planning difficult because the amount of dollars allocated to the non-qualifying basket would vary depending on changes in the value of investments already made. In addition, requiring fair value could complicate compliance for those qualifying funds that make investments frequently, because each investment would result in a requirement to value the fund's assets. Because the rule specifies that the valuation method must be consistently applied, this approach is designed to prevent a qualifying fund, or its adviser, from alternating between valuation methodologies in order to circumvent the 20 percent limit.

Our rule's approach to the valuation method, which allows the use of historical cost in determining compliance with the non-qualifying basket limit, is similar in this respect to rules under the Employee Retirement Income Security Act of 1974 ("ERISA") for funds qualifying as "venture capital operating companies," which generally specify that the value of a fund's investments is determined on a cost basis.[129] Many commenters cited the ERISA rule in connection with comments on other proposed criteria,[130] and hence we believe advisers'

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[129] Under U.S. Department of Labor regulations, a venture capital operating company ("VCOC") is any entity that, as of the date of the first investment (or other relevant time), has at least 50% of its assets (other than short-term investments pending long-term commitment or distribution to investors), valued at cost, invested in venture capital investments. 29 CFR 2510.3-101(d). *See also* Proposing Release, *supra* note 26, at n.70.

[130] For example, a number of commenters urged us to adopt the approach under ERISA that would determine whether or not a fund has satisfied the managerial assistance criterion. *See infra* note 225.

familiarity with the ERISA rule will facilitate compliance with our approach to the 20 percent limit and reduce the burdens associated with compliance.

2. Short-Term Holdings

A qualifying fund may also invest in cash and cash equivalents, U.S. Treasuries with a remaining maturity of 60 days or less and shares of registered money market funds.[131] A qualifying fund need not include its investments in these short-term holdings when determining whether it satisfies the 20 percent limit for non-qualifying investments.[132]

Most commenters that addressed the cash element of the proposal did not disagree with our approach to the cash element but urged us to expand it to include money market funds,[133] any U.S. Treasury without regard to maturity,[134] debt issued by foreign governments,[135] repurchase agreements,[136] and certain highly rated corporate commercial paper.[137] Many commenters did not provide a rationale, other than business practice, for expanding the cash element to include these other types of investments or discuss whether these changes would also permit other types

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131 Rule 203(l)-1(c)(6).

132 Rule 203(l)-1(a)(2). As proposed, a venture capital fund would have been defined as a fund that invested *solely* in certain investments, including specified cash instruments. Proposed rule 203(l)-1(a)(2)(ii). In the final rule, a venture capital fund is defined as a fund that holds *no more* than 20% of its committed capital in assets that are not qualifying investments, excluding for this purpose short-term holdings (which is defined to include specified cash instruments). Rule 203(l)-1(a)(2). The general focus of both the proposal and the final rule is on the types of investments in which a qualifying fund may invest. As a result of the modifications to the rule to incorporate a non-qualifying basket, we are excluding short-term holdings from the calculation of qualifying and non-qualifying investments.

133 Comment Letter of Federated Investors, Inc. (Jan. 18, 2011); IVP Letter; Merkl Letter.

134 *See, e.g.*, Dechert General Letter; IVP Letter. *See also* Shearman Letter; SVB Letter (also argued that Treasuries pose no systemic risk issues).

135 Dechert General Letter; Commenter Letter of European Fund and Asset Management Association (Jan. 24, 2011) (“EFAMA Letter”); Merkl Letter.

136 IVP Letter; NVCA Letter.

137 Sevin Rosen Letter.

of funds to meet the definition. One commenter did note, however, that short-term investments are typically held during the period between a capital call and funding by investors and invested in instruments that may provide higher returns than the cash items identified in the proposed rule.[138]

The Commission recognizes that a broader definition of short-term holdings could yield venture capital funds greater returns.[139] The exclusion of short-term holdings from a qualifying fund's assets for purposes of the 20 percent test, however, recognizes that such holdings are not ordinarily held as part of the fund's investment portfolio but as a cash management tool.[140] Advisers to venture capital funds that wish to invest in longer-term or higher yielding debt may make use of the non-qualifying basket for such investments. We are, however, modifying the definition to include as short-term holdings shares of registered money market funds that are regulated under rule 2a-7 under the Investment Company Act,[141] which we understand are commonly held for purposes of cash management.[142]

The rule defines short-term holdings to include "cash and cash equivalents" by reference to rule 2a51-1(b)(7)(i) under the Investment Company Act.[143] We did not receive any comments on this aspect of the proposal and are adopting it without modification. Rule 2a51-1, however, is

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138 NVCA Letter.

139 *See, e.g.*, NVCA Letter.

140 We do not view investing in short-term holdings as being a venture capital strategy; however, for purposes of the exemption, a qualifying fund could invest in short-term holdings as part of implementing its investment strategy. *See also infra* Section II.A.7.

141 Rule 203(l)-1(c)(6).

142 *See, e.g.*, NVCA Letter.

143 Rule 2a51-1(b)(7) under the Investment Company Act provides that cash and cash equivalents include foreign currencies "held for investment purposes" and "(i) [b]ank deposits, certificates of deposit, bankers acceptances and similar bank instruments held for investment purposes; and (ii) [t]he net cash surrender value of an insurance policy." 17 CFR 270.2a51-1(b)(7).

used to determine whether an owner of an investment company excluded by reason of section 3(c)(7) of the Investment Company Act meets the definition of a qualified purchaser by examining whether such owner holds sufficient "investments" (generally securities and other assets held for investment purposes).[144] We are not defining a venture capital fund's cash holdings by reference to whether the cash is held "for investment purposes" or to the net cash surrender value of an insurance policy. Furthermore, since rule 2a51-1 does not explicitly include short-term U.S. Treasuries, which we believe would be an appropriate form of cash equivalent for a venture capital fund to hold pending investment in a portfolio company or distribution to investors, our rule includes short-term U.S. Treasuries with a remaining maturity of 60 days or less.[145]

3. Qualifying Portfolio Company

Under the rule, qualifying investments generally consist of equity securities issued by a qualifying portfolio company. A "qualifying portfolio company" is defined as any company that: (i) is not a reporting or foreign traded company and does not have a control relationship with a reporting or foreign traded company; (ii) does not incur leverage in connection with the investment by the private fund and distribute the proceeds of any such borrowing to the private fund in exchange for the private fund investment; and (iii) is not itself a fund (*i.e.*, is an operating

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[144] *See generally* sections 2(a)(51) and 3(c)(7) of the Investment Company Act; 17 CFR 270.2a51-1(b) and (c).

[145] We have treated debt securities with maturities of 60 days or less differently than debt securities with longer maturities under our rules. In particular, we have recognized that the potential for fluctuation in those shorter-term securities' market value has decreased sufficiently that, under certain conditions, we allow certain open-end investment companies to value them using amortized cost value rather than market value. *See Valuation of Debt Instruments by Money Market Funds and Certain Other Open-End Investment Companies*, Investment Company Act Release No. 9786 (May 31, 1977) [42 FR 28999 (June 7, 1977)]. We believe that the same consideration warrants treating U.S. Treasury securities with a remaining maturity of 60 days or less as more akin to cash equivalents than Treasuries with longer maturities for purposes of the definition of venture capital fund.

company).[146] We are adopting the rule substantially as proposed, with modifications to the leverage criterion in order to address certain concerns raised by commenters. We describe each element of a qualifying portfolio company below. We understand each of the criteria to be characteristic of issuers of portfolio securities held by venture capital funds.[147] Moreover, collectively, we believe these criteria would operate to exclude most private equity funds and hedge funds from the definition.

a. Not a Reporting Company

Under the rule, a qualifying portfolio company is defined as a company that, at the time of any investment by a qualifying fund, is not a "reporting or foreign traded" company (a "reporting company") and does not control, is not controlled by or under common control with, a reporting company.[148] Under the definition, a venture capital fund may continue to treat as a qualifying investment any previously directly acquired equity security of a portfolio company

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146 Rule 203(l)-1(c)(4). In the Proposing Release, we used the defined term "publicly traded" company, but are modifying the rule to use the defined term "reporting or foreign traded" company to match more closely the defined term and to make clear that certain companies that have issued securities that are traded on a foreign exchange are covered by the definition. *See* proposed rule 203(l)-1(c)(3) and (4).

147 *See* Proposing Release, *supra* note 26, sections II.A.1.a.-II.A.1.e.

148 Rule 203(l)-1(c)(4)(i); rule 203(l)-1(c)(5) (defining a "reporting or foreign traded" company as one that is subject to the reporting requirements under section 13 or 15(d) of the Exchange Act, or has a security listed or traded on any exchange or organized market operating in a foreign jurisdiction). This definition is similar to rule 2a51-1 under the Investment Company Act (defining "public company," for purposes of the qualified purchaser standard, as "a company that files reports pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934"), and rule 12g3-2 under the Exchange Act (conditioning a foreign private issuer's exemption from registering securities under section 12(g) of the Exchange Act if, among other conditions, the "issuer is not required to file or furnish reports" pursuant to section 13(a) or section 15(d) of the Exchange Act). 17 CFR 270.2a51-1; 17 CFR 240.12g3-2. Under the rule, securities of a "reporting or foreign traded company" include securities of non-U.S. companies that are listed on a non-U.S. market or non-U.S. exchange. Rule 203(l)-1(c)(5).

that subsequently becomes a reporting company.[149] Moreover, after a company becomes a reporting company, a qualifying fund could acquire the company's publicly traded (or foreign traded) securities in the secondary markets, subject to the availability of the fund's non-qualifying basket.

As we discussed in the Proposing Release, venture capital funds provide operating capital to companies in the early stages of their development with the goal of eventually either selling the company or taking it public.[150] Unlike other types of private funds, venture capital funds are characterized as not trading in the public markets, but may sell portfolio company securities into the public markets once the portfolio company has matured.[151] As of year-end 2010, U.S.

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149 Rule 203(l)-1(c)(4)(i) (defining a qualifying portfolio company as any company that at the time of any investment by a venture capital fund is not a reporting or foreign traded company).

150 *See* Testimony of James Chanos, Chairman, Coalition of Private Investment Companies, July 15, 2009, at 4 ("[V]enture capital funds are an important source of funding for start-up companies or turnaround ventures."); National Venture Capital Association Yearbook 2010 ("NVCA Yearbook 2010"), at 7-8 (noting that venture capital is a "long-term investment" and the "payoff [to the venture capital firm] comes after the company is acquired or goes public."); George W. Fenn, Nellie Liang and Stephen Prowse, The Economics of the Private Equity Market, December 1995, 22, n.61 and accompanying text ("Fenn *et al*.") ("Private sales" are not normally the most important type of exit strategy as compared to IPOs, yet of the 635 successful portfolio company exits by venture capitalists between 1991-1993 "merger and acquisition transactions accounted for 191 deals and IPOs for 444 deals." Furthermore, between 1983 and 1994, of the 2,200 venture capital fund exits, 1,104 (approximately 50%) were attributed to mergers and acquisitions of venture-backed firms.). *See also* Jack S. Levin, Structuring Venture Capital, Private Equity and Entrepreneurial Transactions, 2000 ("Levin") at 1-2 to 1-7 (describing the various types of venture capital and private equity investment business but stating that "the phrase 'venture capital' is sometimes used narrowly to refer only to financing the start-up of a new business"); Anna T. Pinedo & James R. Tanenbaum, Exempt and Hybrid Securities Offerings (2009), Vol. 1 at 12-2 (discussing the role initial public offerings play in providing venture capital investors with liquidity).

151 *See* Testimony of Trevor Loy, Flywheel Ventures, before the Senate Banking Subcommittee on Securities, Insurance and Investment Hearing, July 15, 2009 ("Loy Testimony"), at 5 ("We do not trade in the public markets."). *See also* Testimony of Terry McGuire, General Partner, Polaris Venture Partners, and Chairman, National Venture Capital Association, before the U.S. House of Representatives Committee on Financial Services, October 6, 2009 ("McGuire Testimony") at 11 ("[V]enture capital funds do not typically trade in the public markets and generally limit advisory activities to the purchase and sale of securities of private operating companies in private transactions"); Levin, *supra* note 150, at 1-4 ("A *third* distinguishing feature of venture

venture capital funds managed approximately $176.7 billion in assets.[152] In comparison, as of year-end 2010, the U.S. publicly traded equity market had a market value of approximately $15.4 trillion,[153] whereas global hedge funds had approximately $1.7 trillion in assets under management.[154] The aggregate amount invested in venture capital funds is considerably smaller.[155] Congressional testimony asserted that these funds may be less connected with the public markets and may involve less potential for systemic risk.[156] This appears to be a key consideration by Congress that led to the enactment of the venture capital exemption.[157] As we discussed in the Proposing Release, the rule we proposed sought to incorporate this

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capital/private equity investing is that the securities purchased are generally privately held as opposed to publicly traded . . . a venture capital/private equity investment is normally made in a privately-held company, and in the relatively infrequent cases where the investment is into a publicly-held company, the [venture capital fund] generally holds non-public securities.") (emphasis in original).

152 National Venture Capital Association Yearbook 2011 ("NVCA Yearbook 2011") at 9, Fig. 1.0.

153 Bloomberg Terminal Database, WCAUUS <Index> (Bloomberg United States Exchange Market Capitalization).

154 Credit Suisse, *2010 Hedge Fund Industry Review*, Feb. 2011 ("Credit Suisse Report"), at 1.

155 In 2010, investors investing in newly formed funds committed approximately $12.3 billion to venture capital funds compared to approximately $85.1 billion to private equity/buyout funds. NVCA Yearbook 2011, *supra* note 152, at 20 at Fig. 2.02. In comparison, hedge funds raised approximately $22.6 billion from investors in 2010. Credit Suisse Report, *supra* note 154, at 1.

156 *See* S. Rep. No. 111-176, *supra* note 6, at 74-5 (noting that venture capital funds "do not present the same risks as the large private funds whose advisers are required to register with the SEC under this title [IV]. Their activities are not interconnected with the global financial system, and they generally rely on equity funding, so that losses that may occur do not ripple throughout world markets but are borne by fund investors alone. Terry McGuire, Chairman of the National Venture Capital Association, wrote in congressional testimony that 'venture capital did not contribute to the implosion that occurred in the financial system in the last year, nor does it pose a future systemic risk to our world financial markets or retail investors.'"). *See also* Loy Testimony, *supra* note 151, at 7 (noting the factors by which the venture capital industry is exposed to "entrepreneurial and technological risk not systemic financial risk"); McGuire Testimony, *supra* note 151, at 6 (noting that the "venture capital industry's activities are not interwoven with U.S. financial markets"). *See also* Group of Thirty, Financial Reform: A Framework for Financial Stability, January 15, 2009, at 9 (discussing the need for registration of managers of "private pools of capital that employ substantial borrowed funds" yet recognizing the need to exempt venture capital from registration).

157 *See supra* note 156.

Congressional understanding of the nature of investments of a venture capital fund, and these principles guided our consideration of the proposed venture capital fund definition.[158] The proposed rule would have required that a qualifying fund invest primarily in equity securities of companies that are not capitalized by the public markets.[159]

Several commenters asserted that the definition should not exclude securities of reporting companies.[160] Most, however, did not object to the rule's limitation on investments in non-reporting companies, but instead sought a more flexible definition that would include some level of investments in reporting companies under certain conditions. For example, certain commenters supported venture capital fund investments in reporting companies only if, at the time the company becomes a reporting company, the fund continued to hold at least a majority of its original investment made when the company was a non-reporting company.[161] Some of these commenters asserted that public offerings, which trigger reporting requirements under the federal

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158 *See* Proposing Release, *supra* note 26, at n.43 and n.60 and following text.

159 Most commenters did not express any objection to our proposed definition of "publicly traded," although one commenter did disagree with the proposed definition's approach to foreign traded securities. This commenter argued that the proposed rule should be modified to "cover securities that have been publicly offered to investors in a foreign jurisdiction and equity securities that are widely held and traded over-the-counter in a foreign jurisdiction." Merkl Letter. We decline to adopt this approach because the definition would require us to define what constitutes a "public offering" notwithstanding the laws of foreign regulators and legislatures.

160 *See* Bessemer Letter; IVP Letter (also suggested additional conditions); Merkl Letter. One commenter also suggested that the definition should not exclude investments in companies that may be deemed to be "controlled" by a public company (or its venture capital investment division). *See* Comment Letter of Berkeley Center for Law, Business and the Economy (Feb. 1, 2011) ("BCLBE Letter"). *See also* Dechert General Letter (argued that restricting the application of the control element may be necessary because an adviser to a venture capital fund could be controlled by a public company, and might itself be deemed to control a portfolio company as a result of its prior investments). Under our rule, a venture capital fund could invest in such companies under the non-qualifying basket.

161 ATV Letter; BIO Letter; NVCA Letter. *See also* Davis Polk Letter; InterWest Letter; McDonald Letter; Mesirow Letter; PTV Sciences Letter. A number of commenters supported expanding the proposed definition but without additional conditions. *See, e.g.*, BioVentures Letter; ESP Letter; Quaker BioVentures Letter; SV Life Sciences Letter.

securities laws, were viewed as an additional financing round, with pre-existing venture investors expected to participate.[162] Alternatively, several commenters recommended that a venture capital fund could limit its investment in reporting companies, such as 15 or 20 percent of the fund's capital commitments.[163]

We understand that venture capital funds seek flexibility to invest in promising portfolio companies, including companies deemed sufficiently profitable to become reporting companies or companies that may be owned directly or indirectly by a public company. Rather than modify the rule to impose additional criteria for investing in reporting companies, however, we have adopted a limit of 20 percent for non-qualifying investments, which may be used to hold securities of reporting companies. We believe that the 20 percent limit appropriately balances commenters' expressed desire for greater flexibility to accommodate existing business practices while providing sufficient limits on the extent of investments that would implicate Congressional statements regarding the interconnectedness of venture capital funds with the public markets.[164]

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162 *See, e.g.*, Alta Partners Letter; Gunderson Dettmer Letter; InterWest Letter; McDonald Letter; NVCA Letter; Quaker BioVentures Letter. *See also* Bessemer Letter; BIO Letter; Lowenstein Letter.

163 Alta Partners Letter (supported limiting investments in public companies to 15% of fund capital commitments); Gunderson Dettmer Letter (supported limiting investments in public securities to 20% of fund capital commitments). *See also* Davis Polk Letter (supported limiting investments in public companies to 20% of fund capital commitments provided the fund continues to hold a majority of its original investment in the company when it was private); SVB Letter (supported investments in public securities but did not identify a percentage threshold).

164 *See supra* Section II.A.1.b. One commenter argued that, in addition to funds that would satisfy the proposed definition, a venture capital fund should include any fund that invests at least 75% of its capital in privately held "domestic small business" as defined in the Small Business Investment Act (the "SBIA") regulations, regardless of the equity/debt nature of the investment. *See* NASBIC/SBIA Letter. In the Proposing Release, we noted our concerns with adopting a definition for a "small" company, including reliance on the SBIA regulatory standards for treatment as a "small" company, which generally imposes specific tests for net worth, net income or number of employees for each type of company, depending on its geographic location and industry classification. *See* Proposing Release, *supra* note 26, at n.69 and accompanying and following text. We have considered the issues raised in the NASBIC/SBIA Letter and continue to

Under our rule, a qualifying portfolio company is defined to include a company that is not a reporting company (and does not have a control relationship with a reporting company) at the time of each fund investment.[165] However, one commenter observed that an existing investment in a portfolio company that ultimately becomes a successful venture capital investment (such as when the company issues its securities in a public offering or becomes a reporting company) should not result in the investment becoming a non-qualifying investment.[166] We agree. Under the rule, such an investment would not become a non-qualifying investment because the definition focuses on the time at which the venture capital fund acquires the particular equity security issued by a portfolio company and does not limit the definition of qualifying portfolio company solely to companies that are and remain non-reporting companies. Under this approach, an adviser could continue to rely on the exemption even if the venture capital fund's portfolio ultimately consisted entirely of securities that become securities of reporting companies. We believe that our approach would give advisers to venture capital funds sufficient flexibility to exercise their business judgment on the appropriate time to dispose of portfolio company investments – whether that occurs at a time when the company is or is not a reporting company.[167] Moreover, under the federal securities laws, a person, such as a venture capital fund, that is deemed to be an affiliate of a company may be limited in its ability to

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believe that a qualifying portfolio company should not be defined by reference to whether a company is "small" for the reasons cited in the Proposing Release.

165 *See* rule 203(l)-1(c)(4)(i).

166 PTV Sciences Letter (stating that following a merger or public offering of a qualifying portfolio company's securities, the shares held by the fund "are turned into profits to our investors").

167 *See* Proposing Release, *supra* note 26, at n.55 and following text.

dispose of the company's securities.[168] Under the final rule, a qualifying fund would not be in the position of having to dispose of securities of a qualifying portfolio company that subsequently becomes a reporting company.

b. Portfolio Company Leverage

Rule 203(l)-1 defines a qualifying portfolio company for purposes of the exemption as one that does not borrow or issue debt obligations in connection with the venture capital fund's investment in the company and distribute to the fund the proceeds of such borrowing or issuance in exchange for the fund's investment.[169] As a consequence, certain types of funds that use leverage or finance their investments in portfolio companies or the buyout of existing investors with borrowed money (*e.g.*, leveraged buyout funds, which are a different subset of private equity funds) would not meet the rule's definition of a venture capital fund.[170] As discussed in greater detail below and in the Proposing Release, we believe that Congress did not intend the

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168 *See* sections 2(a)(11) (defining "underwriter") and 5 of the Securities Act. *See also* E.H. Hawkins, SEC Staff No-Action Letter (June 26, 1997) (staff explained how the term "underwriter" in the Securities Act restricts resales of securities by affiliates of issuing companies).

169 Rule 203(l)-1(c)(4)(ii).

170 Leveraged buyout funds are private equity funds that will "borrow significant amounts from banks to finance their deals—increasing the debt-to-equity ratio of the acquired companies . . . " U.S. Govt. Accountability Office, Private Equity: Recent Growth in Leveraged Buyouts Exposed Risks that Warrant Continued Attention (2008) ("GAO Private Equity Report"), at 1. A leverage buyout fund in 2005 typically financed a deal with 34% equity and 66% debt. *Id*. at 13. *See also* Fenn *et al*., *supra* note 150, at 23 (companies that have been taken private in a leveraged buyout (or "LBO") transaction generally "spend less on research and development, relative to assets, and have a greater proportion of fixed assets; their debt-to-assets ratios are high, above 60 percent, and are two to four times those of venture-backed firms." Moreover, compared to venture capital backed companies, LBO-private equity backed companies that are taken public typically use proceeds from an IPO to reduce debt whereas new venture capital backed firms tend to use proceeds to fund growth.); Testimony of Mark Tresnowksi, General Counsel, Madison Dearborn Partners, LLC, on behalf of the Private Equity Council, before the Senate Banking Subcommittee on Securities, Insurance and Investment, July 15, 2009, at 2 (indicating that portfolio companies in which private equity funds invest typically have 60% debt and 40% equity).

venture capital fund definition to apply to these types of private equity funds.[171]

We proposed to define a qualifying portfolio company as a company that does not borrow "in connection" with a venture capital fund investment. We also proposed to define a qualifying portfolio company as a company that does not participate in an indirect buyout involving a qualifying fund (as a corollary to our proposed limitation on venture capital fund acquisitions of portfolio company securities through secondary transactions, *i.e.*, direct buyouts).[172] We proposed these elements to distinguish between venture capital funds that provide capital to portfolio companies for operating and business purposes (in exchange for an equity investment) and leveraged buyout funds, which acquire controlling equity interests in operating companies through the "buyout" of existing security holders or which finance such investments or buyouts with borrowed money.[173] We proposed these elements of the qualifying portfolio company definition because of the focus on leverage in the Dodd-Frank Act as a potential contributor to systemic risk as discussed by the Senate Committee report,[174] and the testimony before Congress that stressed the lack of leverage in venture capital investing.[175]

Some commenters argued that defining a venture capital fund as a fund that does not participate in buyouts was too restrictive or too difficult to apply.[176] Most of the commenters

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171 *See* discussion in section II.A.1.c. and d. of the Proposing Release, *supra* note 26.

172 Proposed rules 203(l)-1(a)(2)(i); (c)(4)(ii) and (c)(4)(iii).

173 *See generally* Proposing Release, *supra* note 26, at sections II.A.1.c. and d.

174 *See* S. Rep. No. 111-176, *supra* note 6, at 74 ("The Committee believes that venture capital funds, a subset of private investment funds specializing in long-term equity investment in small or start-up businesses, do not present the same risks as the large private funds whose advisers are required to register with the SEC under this title."); *id*. at 75 (concluding that private equity funds that use limited or no leverage at the fund level engage in activities that do not pose risks to the wider markets through credit or counterparty relationships).

175 *See* Proposing Release, *supra* note 26, at n.100.

176 *See, e.g.*, McGuireWoods Letter; NVCA Letter; Pine Brook Letter.

who addressed the issue opposed a definition that excluded any buyouts of portfolio company securities by venture capital funds.[177] Some commenters argued that because a venture capital fund could, under the proposed rule, acquire up to 20 percent of portfolio company securities in secondary transactions, indirect buyouts achieved at the portfolio company level should not be precluded.[178] Some commenters stated that buyouts are an important means of providing liquidity to portfolio company founders, employees, former employees and vendors/service providers,[179] while others argued that buyouts occurring as a result of recapitalizations[180] or conversions of permissible bridge loans[181] should not preclude a fund from relying on the definition.[182]

We have eliminated the proposed indirect buyout criterion in the final rule. Because the non-qualifying basket does not exclude secondary market transactions (or other buyouts of existing security holders), it would be inconsistent to define a venture capital fund as a fund that does not participate in a buyout.

We are retaining and clarifying, however, the leveraged buyout criterion as it relates to qualifying portfolio companies. We had proposed to define a qualifying portfolio company as a

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177 One commenter sought interpretative guidance on which buyout transactions would be considered to be "in connection with" a venture capital fund investment. Mesirow Letter. *See also* McGuireWoods Letter; NVCA Letter (discussing some interpretative issues with the "in connection with" language).

178 ATV Letter; NVCA Letter. *See also* ABA Letter (also recommending that the buyout bucket be increased to 30%); Charles River Letter (supported a 20% buyout limit to accommodate the increasing industry use of buyouts); First Round Letter (supported 25% buyout limit for each deal and a 20% limit for all fund investments in order to facilitate liquidity to founders).

179 *See*, *e.g.*, Davis Polk Letter; ESP Letter; SVB Letter.

180 Alta Partners Letter; BioVentures Letter.

181 ATV Letter; NVCA Letter.

182 *See also* Pine Brook Letter (suggesting "careful drafting" that would not preclude transactions in the normal course of business by defining a set of prohibited buyout transactions (*e.g.*, "leveraged dividend recapitalizations")).

company that, among other things, does not borrow "in connection" with a venture capital fund investment. As noted above, we proposed this element to distinguish venture capital funds from leveraged buyout funds, and we continue to believe that this remains an important distinction. We believe that these differences (*i.e.*, the use of buyouts and associated leverage) distinguish venture capital funds from buyout private equity funds for which Congress did not provide an exemption.[183]

One of the distinguishing features of venture capital funds is that, unlike many hedge funds and private equity funds, they invest capital directly in portfolio companies for the purpose of funding the expansion and development of the company's business rather than buying out existing security holders, otherwise purchasing securities from other shareholders, or leveraging the capital investment with debt financing.[184] Testimony received by Congress and our research suggest that venture capital funds provide capital to many types of businesses at different stages of development,[185] generally with the goal of financing the expansion of the company[186] and

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183 *See supra* note 174 and accompanying text.

184 *See* Loy Testimony, *supra* note 151, at 2 ("Although venture capital funds may occasionally borrow on a short-term basis immediately preceding the time when the cash installments are due, they do not use debt to make investments in excess of the partner's capital commitments or 'lever up' the fund in a manner that would expose the fund to losses in excess of the committed capital or that would result in losses to counter parties requiring a rescue infusion from the government."). *See also infra* notes 189-191; Mark Heesen & Jennifer C. Dowling, National Venture Capital Association, *Venture Capital & Adviser Registration* (October 2010), materials submitted in connection with the Commission's Government-Business Forum on Small Business Capital Formation (summarizing the differences between venture capital funds and buyout and hedge funds), *available at* http://www.sec.gov/info/smallbus/2010gbforumstatements.htm.

185 *See, e.g.*, McGuire Testimony, *supra* note 151, at 1; NVCA Yearbook 2010, *supra* note 150; PricewaterhouseCoopers/National Venture Capital Association MoneyTree Report, Q4 2009/Full-year 2009 Report (providing data on venture capital investments in portfolio companies); James Schell, Private Equity Funds: Business Structure and Operations (2010), at § 1.03[1] ("Schell"), at §1.03[1]; PAUL A. GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE, at 459 (MIT Press 2004), at 178, 180 table 8.2 (displaying percentage of annual venture capital investments by stage of development and classifying "early stage" as seed, start-up, or early stage and "late stage" as expansion, second, third, or bridge financing).

helping it progress to the next stage of its development through successive tranches of investment (*i.e.*, "follow-on" investments) if the company reaches agreed-upon milestones.[187]

In contrast, private equity funds that are identified as buyout funds typically provide capital to an operating company in exchange for majority or complete ownership of the company,[188] generally achieved through the buyout of existing shareholders or other security holders and financed with debt incurred by the portfolio company,[189] and compared to venture capital funds, hold the investment for shorter periods of time.[190] As a result of the use of the

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186 *See* McGuire Testimony, *supra* note 151, at 1; Loy Testimony, *supra* note 151, at 3 ("Once the venture fund is formed, our job is to find the most promising, innovative ideas, entrepreneurs, and companies that have the potential to grow exponentially with the application of our expertise and venture capital investment."). *See also* William A. Sahlman, *The Structure and Governance of Venture-Capital Organizations*, Journal of Financial Economics 27 (1990), at 473, 503 ("Sahlman") (noting venture capitalists typically invest more than once during the life of a company, with the expectation that each capital investment will be sufficient to take the company to the next stage of development, at which point the company will require additional capital to make further progress).

187 *See* Sahlman, *supra* note 186, at 503; Loy Testimony, *supra* note 151, at 3 ("[W]e continue to invest additional capital into those companies that are performing well; we cease follow-on investments into companies that do not reach their agreed upon milestones.").

188 GAO Private Equity Report, *supra* note 170, at 8 ("A private equity-sponsored LBO generally is defined as an investment by a private equity fund in a public or private company (or division of a company) for majority or complete ownership.").

189 *See* Annalisa Barrett *et al*., Prepared by the Corporate Library Inc., under contract for the IRRC Institute, What is the Impact of Private Equity Buyout Fund Ownership on IPO Companies' Corporate Governance?, at 7 (June 2009) ("Barrett *et al*.") ("In general, VC firms provide funding to companies in early stages of their development, and the money they provide is used as working capital for the firm. Buyout firms, in contrast, work with mature companies, and the funds they provide are used to compensate the firm's existing owners."); Ieke van den Burg and Poul Nyrup Rasmussen, Hedge Funds and Private Equity: A Critical Analysis (2007), at 16-17 ("van den Burg"); Sahlman, *supra* note 186, at 517. *See also* Tax Legislation: CRS Report, Taxation of Hedge Fund and Private Equity Managers, Tax Law and Estate Planning Course Handbook Series, Practicing Law Institute (Nov. 2, 2007) at 2 (noting that in a leveraged buyout "private equity investors use the proceeds of debt issued by the target company to acquire all the outstanding shares of a public company, which then becomes private").

190 Unlike venture capital funds, which generally invest in portfolio companies for 10 years or more, private equity funds that use leveraged buyouts invest in their portfolio companies for shorter periods of time. *See* Loy Testimony, *supra* note 151, at 3 (citing venture capital fund investments periods in portfolio companies of five to 10 years or longer); van den Burg, *supra* note 189, at 19

capital provided and the incurrence of this debt, following the buyout fund investment, the operating company may carry debt several times its equity and may devote significant levels of its cash flow and corporate earnings to repaying the debt financing, rather than investing in capital improvement or business operations.[191]

Some commenters agreed that distinguishing between venture capital and other private funds with reference to a portfolio company's leverage and indirect buyouts is important.[192] Many commenters, however, urged a more narrowly drawn restriction on a portfolio company's ability to borrow (or issue debt) or to effect indirect buyouts.[193] Some argued that the manner in which proceeds from indebtedness are used by a portfolio company (*e.g.*, distributed by the company to the venture capital fund) better distinguishes venture capital funds from leveraged buyout private equity funds.[194] Nevertheless, the majority of commenters who addressed this criterion supported a leverage criterion that would be more specific, or limited, in scope,[195]

(noting that LBO investors generally retain their investment in a listed company for 2 to 4 years or even less after the company goes public). *See also* Paul A. Gompers, *The Rise and Fall of Venture Capital*, Business And Economic History, vol. 23, no. 2, Winter 1994, at 17 (stating that "an LBO investment is significantly shorter than that of a comparable venture capital investment. Assets are sold off almost immediately to meet debt burden, and many companies go public again (in a reverse LBO) in a very short period of time.").

191 *See* Barrett *et al.*, *supra* note 189. *See also* Fenn *et al.*, *supra* note 150, at 23 (companies that have been taken private in an LBO transaction generally "spend less on research and development, relative to assets, and have a greater proportion of fixed assets; their debt-to-assets ratios are high, above 60%, and are two to four times those of venture-backed firms." Moreover, compared to venture capital backed companies, LBO-private equity backed companies that are taken public typically use proceeds from an IPO to reduce debt whereas new venture capital backed firms tend to use proceeds to fund growth.).

192 *See, e.g.*, AFL-CIO Letter; Sen. Levin Letter; Pine Brook Letter.

193 *See, e.g.*, ATV Letter; Charles River Letter; NVCA Letter; Oak Investment Letter; Pine Brook Letter.

194 *See, e.g.*, NVCA Letter; Pine Brook Letter; SV Life Sciences Letter; Vedanta Letter.

195 *See, e.g.*, ATV Letter; Charles River Letter (supports modifying the rule so that up to 20% of fund capital commitments may be invested in portfolio companies that do not adhere to the leverage condition provided that the venture capital fund is not the party providing the leverage to

focusing on the use of proceeds derived from portfolio company leverage.[196] Commenters suggested that the rule define leverage as leverage incurred for the purpose of buying out shareholders at the demand of the venture capital fund[197] or for returning capital to the fund,[198] and not, for example, define leverage to include indebtedness incurred to pay for a qualifying portfolio company's operating expenses.[199]

Some commenters argued that the proposed "in connection with" element would be difficult to apply, arguing that the standard was too vague or raised too many interpretative issues.[200] In response to our request for comment, many commenters sought confirmation that the limitation on portfolio company leverage would be triggered only in the instances of leverage provided to the portfolio company by the venture capital fund or if portfolio company borrowing

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the company); NVCA Letter; Comment Letter of the Securities Regulation Committee of the Business Law Section of the New York State Bar Association, Apr. 1, 2011 ("NYSBA Letter"); SVB Letter.

196 Although two commenters supported the leverage limitation as proposed (*see* AFL-CIO Letter (also supporting a specific prohibition on borrowing by a portfolio company to pay dividends or fees to the venture capital fund); Sen. Levin Letter (together with the equity investment requirement, the definition appropriately excludes leveraged buyout funds)), two other commenters opposed it, arguing that qualifying portfolio company leverage should not be restricted at all (*see* ESP Letter (limits on leverage would prevent portfolio companies from receiving lending from venture debt funds and state governments and lenders rather than regulators should determine the appropriate level of portfolio company debt); Merkl Letter (young negative EBITDA companies would not be able to obtain significant amounts of debt and hence no leverage prohibition is required)). *See also* NASBIC/SBIA Letter (portfolio companies should not be precluded from accessing leverage); Sevin Rosen Letter, Pine Brook Letter (each expressed support for a use of proceeds approach).

197 *See, e.g.,* Gunderson Dettmer Letter; McDonald Letter; NVCA Letter; SVB Letter.

198 *See, e.g.,* McDonald Letter; NVCA Letter.

199 Gunderson Dettmer Letter; Pine Brook Letter; Trident Letter; Vedanta Letter. One commenter suggested that a use of proceeds test would be difficult to enforce because such a test would need to be extremely detailed in order to prevent circumvention. *See* Merkl Letter.

200 *See, e.g.*, Merkl Letter; Sevin Rosen Letter; SVB Letter.

were effected in satisfaction of a contractual obligation with the venture capital fund.[201]

After careful consideration of the intended purpose of the leverage limitation of the proposed rule and the concerns raised by commenters, we are modifying the qualifying portfolio company leverage criterion to define a qualifying portfolio company as any company that does not both borrow (or issue debt) in connection with a venture capital fund investment *and* distribute the proceeds of such borrowing or issuance to the venture capital fund *in exchange for* the fund's investment. In contrast to the proposed rule, the final rule more specifically delineates the types of leveraged transactions involving a qualifying fund (*i.e*., a company's distribution of proceeds received in a debt offering to the qualifying fund) that would result in the company being excluded from the definition of a qualifying portfolio company. We believe that these modifications more closely achieve our goal of distinguishing advisers to venture capital funds from other types of private funds for which Congress did not provide an exemption because it looks to the substance, not just the form, of a transaction or series of transactions.

This definition of qualifying portfolio company would only exclude companies that borrow in connection with a venture capital fund's investment and distribute such borrowing proceeds to the venture capital fund in exchange for the investment, but would not exclude companies that borrow in the ordinary course of their business (*e.g.*, to finance inventory or capital equipment, manage cash flows, meet payroll, *etc.*). Under the rule, a venture capital fund could provide financing or loans to a portfolio company, provided that the financing meets the definition of equity security or is made subject to the 20 percent limit for non-qualifying investments. Although we would generally view any financing to a portfolio company that was

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201 *See, e.g.*, ABA Letter; ATV Letter; Bessemer Letter; Mesirow Letter; NVCA Letter; SV Life Sciences Letter. *See also* Proposing Release, *supra* note 26, discussion at section II.A.1.c.

provided by, or was a condition of a contractual obligation with, a fund or its adviser as part of the fund's investments in the company as being a type of financing that is "in connection with" the fund's investment, the definition's limitation would only apply if the proceeds of such financing were distributed to the venture capital fund in exchange for its investment. Moreover, subsequent distributions to the venture capital fund solely because it is an existing investor would not be inconsistent with this criterion. We believe that this modification to the rule adequately distinguishes between venture capital funds and leveraged buyout funds and provides a simpler and clearer approach to determining whether or not a qualifying portfolio company satisfies the definition.

c. Operating Company

Rule 203(l)-1 defines the term qualifying portfolio company for the purposes of the exemption to exclude any private fund or other pooled investment vehicle.[202] Under the rule, a qualifying portfolio company could not be another private fund, a commodity pool or other "investment companies."[203] We are adopting this criterion because Congress did not express an intent to include venture capital funds of funds within the definition.[204] In the Senate Report, Congress characterized venture capital as a subset of private equity "specializing in long-term

[202] Rule 203(l)-1(c)(4)(iii). For this purpose, pooled investment vehicles include investment companies, issuers relying on rule 3a-7 under the Investment Company Act and commodity pools. 17 CFR 270.3a-7.

[203] Under the "holding out" criterion (discussed in Section II.A.7. below), a fund that represents itself as pursuing a venture capital strategy to investors implies that the fund invests primarily in operating companies and not for example in entities that hold oil and gas leases.

[204] One commenter agreed that "there is no indication that Congress intended the venture capital exemption to apply to 'funds of funds,'" but argued that the qualifying portfolio company definition was "unduly restrictive" because it would exclude such funds of funds and discourage use of special purpose vehicles. ABA Letter.

equity investment in small or start-up businesses"[205] and did not refer to funds investing in other funds. Moreover, testimony to Congress described venture capital investments in operating companies rather than other private funds.[206]

Moreover, without this definitional criterion, a qualifying fund could circumvent the intended scope of the rule by investing in other pooled investment vehicles that are not themselves subject to the definitional criteria under our rule.[207] For example, without this criterion, a venture capital fund could circumvent the intent of the rule by incurring off-balance sheet leverage or indirectly investing in reporting companies in excess of the 20 percent limit for non-qualifying investments.[208] Our exclusion is similar to the approach of other definitions of "venture capital" discussed in the Proposing Release, which limit investments to operating companies and thus would exclude investments in other private funds or securitized asset vehicles.[209]

Many commenters opposed the operating company criterion and recommended that the rule include fund of venture capital fund structures.[210] Some commenters supported no limits on

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205 S. Rep. No. 111-176, *supra* note 6, at 74.

206 *See generally* Loy Testimony, *supra* note 151, and McGuire Testimony, *supra* note 151.

207 One commenter indicated that it was "sympathetic" to the Commission's concerns about the use of fund of funds structures to circumvent the intended purpose of the exemption, and agreed that such "investments would unacceptably heighten the possibility for abuse." *See* NVCA Letter (suggesting that the Commission address this concern by applying the venture capital fund leverage limit on a full "look-through" basis to the underlying funds).

208 Similarly, a qualifying fund could not, for example, invest in an investment management entity (*e.g.*, a general partner entity) that in turn invests in another pooled vehicle, except as an investment under the non-qualifying basket.

209 *See* Proposing Release, *supra* note 26, at nn.70-72 (discussing the California venture capital exemption and the VCOC definition under ERISA, 29 CFR 2510.3-101(d)).

210 *See, e.g.*, NVCA Letter; Sevin Rosen Letter; Comment Letter of VCFA Group (Jan. 21, 2011).

investments in other pooled investment vehicles,[211] while others supported broadening the definition to include funds that invest in other funds if either (i) the underlying funds qualify as venture capital funds (*i.e.*, comply with rule 203(l)-1)[212] or (ii) investment in underlying funds does not exceed a specified threshold (such as a percentage of fund capital).[213] Commenters argued that broadening the definition of qualifying portfolio company was necessary in order to accommodate current business practices,[214] or was appropriate because funds of funds (including secondary funds) provide investors with liquidity or do not pose systemic risk.[215] Other commenters advocated a definition that would permit investments in qualifying portfolio companies held through an intermediate holding company structure formed solely for tax, legal or regulatory reasons.[216]

For purposes of the definition of a qualifying portfolio company, we agree that a fund may disregard a wholly owned intermediate holding company formed solely for tax, legal or

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211 *See, e.g.*, Cook Children's Letter; Leland Fikes Letter; Merkl Letter.

212 *See, e.g.*, ATV Letter, Charles River Letter, NVCA Letter, Sevin Rosen Letter (specifically in the context of funds of "seed" funds); SVB Letter, Vedanta Letter (85% cap for investments in rule 203(l)-1 compliant, unleveraged funds). *See also* Dechert General Letter (suggested that funds investing solely in venture capital funds should be permitted or, in the alternative, investments of up to 20% of committed capital should be permitted in "incubator" funds).

213 First Round Letter (supported investments in underlying funds representing no more than 10% of a fund's called capital, measured at the end of the fund's term); ATV Letter and Charles River Letter (supported investments in underlying funds representing no more than 20% of a fund's committed capital subject to other conditions); PEI Funds Letter (supports "substantial" investment in venture capital investments rather than a specific numerical threshold); Comment Letter of Private Equity Investors, Inc. and Willowbridge Partners, Inc. (Jan. 7, 2011) ("PEI/Willowbridge Letter") (supported investments in other qualifying funds representing at least 50% of the qualifying fund's assets or committed capital) and Comment Letter of Venture Investment Associates (Jan. 24, 2011) ("VIA Letter") (supported investments in underlying funds representing at least 50% of a qualifying fund's capital commitments).

214 *See, e.g.*, ATV Letter, Charles River Letter, Cook Children's Letter, Leland Fikes Letter (each of which cited the use of technology incubators).

215 *See, e.g.*, PEI/Willowbridge Letter and VIA Letter.

216 *See, e.g.*, ABA Letter; Davis Polk Letter; NVCA Letter.

regulatory reasons to hold the fund's investment in a qualifying portfolio company. Such structures are used to address the particular needs of venture capital funds or their investors and are not intended to circumvent the rule's general limitation on investing in other investment vehicles.[217]

We do not agree, however, that Congress viewed funds of venture capital funds as being consistent with the exemption, and continue to believe that this criterion remains an important tool to prevent circumvention of the intended scope of the venture capital exemption. A fund strategy of selecting a venture capital or other private fund in which to invest is different from a strategy of selecting qualifying portfolio companies. Nevertheless, we are persuaded that a venture capital fund's limited ability to invest a limited portion of its assets in other pooled investment vehicles would not be inconsistent with the intent of the rule if the fund primarily invests directly in qualifying portfolio companies. As a result, for purposes of the exemption, investments in other private funds or venture capital funds could be made using the non-qualifying basket.

4. Management Involvement

We are not adopting a managerial assistance element of the rule, as originally proposed. We proposed that advisers seeking to rely on the rule have a significant level of involvement in developing a fund's portfolio companies.[218] We modeled our proposed approach to managerial assistance in part on existing provisions under the Advisers Act and the Investment Company Act dealing with BDCs. These provisions were added over the years to ease the regulatory

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217 *See, e.g.*, Davis Polk Letter for a discussion of these considerations.

218 *See* Proposing Release, *supra* note 26, section II.A.2.

burden on venture capital and other private equity investments.[219] Congress did not use the existing BDC definitions when determining the scope of the venture capital exemption, and the primary policy considerations that led to the adoption of the BDC exemptions differed from those under the Dodd-Frank Act.[220]

Commenters presented several problems with the application of the managerial assistance criterion and its intended scope under the proposed rule. Some objected to the managerial assistance criterion as proposed, arguing that such assistance to (or control of) a portfolio company is not a key or distinguishing characteristic of venture capital investing;[221] that relationships between qualifying funds and qualifying portfolio companies may be less formal and may not constitute management or control of a portfolio company under the proposed rule;[222] or that the discretion to determine the extent of involvement with a portfolio company should not affect a qualifying fund's ability to satisfy the definitional criterion.[223]

Most commenters sought guidance on determining what activities would constitute managerial assistance or "control."[224] Other commenters specifically requested confirmation

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219 *See id.*, at n.123.

220 *See id.*, at section II.A.2.

221 Merkl Letter; SVB Letter (managerial assistance criterion is unnecessary because it does not distinguish venture capital funds from other types of funds providing managerial assistance).

222 ESP Letter.

223 Sevin Rosen Letter.

224 BCLBE Letter; Gunderson Dettmer Letter; McGuireWoods Letter; Shearman Letter. Shearman sought confirmation on whether control included both direct and indirect control, and BCLBE sought confirmation that board representation would be sufficient for control purposes. Other commenters, however, acknowledged that the "offer-only" element of the proposed rule would provide sufficient flexibility for a venture capital fund to alter its relationship with a portfolio company over time. *See, e.g.*, First Round Letter; NVCA Letter. The NVCA and one other commenter did not support imposing specific requirements as to what constituted managerial assistance. *See* NVCA Letter (definitive requirements are not appropriate); Sevin Rosen Letter (opposed requiring board seat or observer rights).

that a management rights letter for purposes of "venture capital operating company" status under ERISA would be sufficient.[225] Finally, some commenters recommended that the rule address syndicated transactions,[226] and provide that the managerial assistance criterion would be satisfied if one fund within the syndicate provided the requisite assistance or control.[227]

We appreciate the difficulties of applying the managerial assistance criterion under the proposed definition and in particular the issues associated with a qualifying fund proving compliance when it participates in a syndicated transaction involving multiple funds. We are persuaded that to modify the rule to specify which activities constitute "managerial assistance" would introduce additional complexity and require us to insert our judgment for that of a venture capital fund's adviser regarding the minimum level of portfolio company involvement that would be appropriate for the fund, rather than enabling investors to select venture capital funds based in part on their level of involvement.[228] We also appreciate that the offer of managerial assistance may not distinguish venture capital funds from other types of funds.

While many venture capital fund advisers do provide managerial assistance, we believe that the managerial assistance criterion, as proposed, does not distinguish these advisers from other advisers, would be difficult to apply and could be unnecessarily prescriptive without creating benefits for investors. As a consequence of our modification to the proposed rule, a

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225 ATV Letter; Charles River Letter; NVCA Letter; Oak Investment Letter; Santé Ventures Letter; Sevin Rosen Letter; Village Ventures Letter.

226 ABA Letter; ESP Letter; McGuireWoods Letter.

227 ABA Letter (asserted that most deals are syndicated deals). *See also* Dechert General Letter; ESP Letter (indicating that in syndicated transactions, there may be varying degrees of managerial involvement by funds participating in the transactions; one fund may take an active role with the other funds taking a more passive role with respect to portfolio companies).

228 For example, one commenter indicated that although it may seek to offer assistance to portfolio companies, not all of the companies have accepted. Charles River Letter. Similarly, a number of venture capital advisers stated that their funds may invest in a significant but non-controlling stake in underlying portfolio companies. *See, e.g.*, ATV Letter; First Round Letter.

qualifying fund is not required to offer (or provide) managerial assistance to, or control any, qualifying portfolio company in order to satisfy the definition.

5. Limitation on Leverage

Under rule 203(l)-1, a venture capital fund is a private fund that does not borrow, issue debt obligations, provide guarantees or otherwise incur leverage, in excess of 15 percent of the fund's capital contributions and uncalled committed capital, and any such borrowing, indebtedness, guarantee or leverage is for a non-renewable term of no longer than 120 calendar days.[229] For purposes of this leverage criterion, any guarantee by the private fund of a qualifying portfolio company's obligations up to the value of the private fund's investment in the qualifying portfolio company is not subject to the 120 calendar day limit.[230]

The 15 percent threshold is determined based on the venture capital fund's aggregate capital commitments. In practice, this means that a qualifying fund could leverage an investment transaction up to 100 percent when acquiring equity securities of a particular portfolio company as long as the leverage amount does not exceed 15 percent of the fund's total capital commitments.

Although a minority of commenters generally supported the leverage criterion as proposed,[231] many commenters sought to broaden it in several ways. Two commenters that generally supported the leveraged criterion also recommended that the criterion exclude uncalled

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229 Rule 203(l)-1(a)(3).

230 *Id.*

231 *See* Sen. Levin Letter; NVCA Letter. *See also* AFL-CIO Letter, AFR Letter (generally supported the leverage limit but also supported excluding uncalled capital commitments); Oak Investment Letter (generally supported the leverage limit, but did not agree that the 120-day limit should apply to guarantees of portfolio company obligations by venture capital funds).

capital commitments so that a qualifying fund could not incur excessive leverage.[232] Although determining the leverage criterion as a percentage of total fund capital commitments may enable a qualifying fund to incur a degree of leverage that represents a disproportionate percentage of the fund's assets early in the life of the fund, the leverage criterion is also constrained by the 120 calendar day limit. Therefore, we do not believe it is necessary to exclude uncalled capital commitments from the leverage criterion.

Other commenters proposed to exclude from the 15 percent leverage limitation capital call lines of credit (*i.e.*, venture capital fund borrowings repaid with proceeds of capital calls from fund investors),[233] or borrowings by a venture capital fund in order to meet fee and expense obligations.[234] One commenter sought to increase the leverage threshold from 15 percent to 20 percent.[235] One commenter, on behalf of many venture capital advisers, however, agreed with the proposed leverage criterion, arguing that venture capital fund financing would generally not exceed 15 percent of fund capital commitments or remain outstanding for longer than 120 days.[236]

We decline to increase the leverage threshold for a qualifying fund under the rule or exclude other certain types of borrowings as requested by some commenters. Our rule defines a venture capital fund by reference to a maximum of 15 percent of borrowings based on our

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232 AFR Letter; AFL-CIO Letter.

233 Cook Children's Letter; Leland Fikes Letter; SVB Letter. We would view a line of credit used to advance anticipated committed capital that remains available for longer than 120 days to be consistent with the criterion, if each drawdown is repaid within 120 days and subsequent drawdowns relate to subsequent capital calls.

234 Dechert General Letter.

235 *See* Charles River Letter (argued that a qualifying fund should be able to borrow, without limit on duration, up to 20% of capital commitments with the consent of its investors).

236 NVCA Letter. *See also* Merkl Letter.

understanding that venture capital funds typically would not incur borrowings in excess of 10 to 15 percent of the fund's total capital contributions and uncalled capital commitments,[237] which commenters have confirmed.[238] We believe that imposing a maximum at the upper range of borrowings typically used by venture capital funds will accommodate existing practices of the vast majority of industry participants.

Our rule specifies that the 15 percent calculation must be determined based on the fund's aggregate capital contributions and uncalled capital commitments.[239] Unlike most registered investment companies or hedge funds, venture capital funds rely on investors funding their capital commitments from time to time in order to acquire portfolio companies.[240] A capital commitment is a contractual obligation to acquire an interest in, or provide the total commitment amount over time to, a fund, when called by the fund. Accordingly, an adviser to venture capital funds manages the fund in anticipation of all investors fully funding their commitments when due and typically has the right to penalize investors for failure to do so.[241] Venture capital funds

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237 *See* Loy Testimony, *supra* note 151, at 6 ("[M]any venture capital funds significantly limit borrowing such that all outstanding capital borrowed by the fund, together with guarantees of portfolio company indebtedness, does not exceed the lesser of (i) 10-15% of total limited partner commitments to the fund and (ii) undrawn limited partner commitments.").

238 NVCA Letter. *See also* Merkl Letter; Oak Investments Letter.

239 Rule 203(l)-1(a)(3).

240 Schell, *supra* note 185, at §1.03[8] ("The typical Venture Capital Fund calls for Capital Contributions from time to time as needed for investments."); *id.* at §2.05[2] (stating that "[venture capital funds] begin operation with Capital Commitments but no meaningful assets. Over a specific period of time, the Capital Commitments are called by the General Partner and used to acquire Portfolio Investments.").

241 *See* Loy Testimony, *supra* note 151, at 5 ("[Limited partners] make their investment in a venture fund with the full knowledge that they generally cannot withdraw their money or change their commitment to provide funds. Essentially they agree to "lock-up" their money for the life of the fund . . . "). *See also* Stephanie Breslow & Phyllis Schwartz, Private Equity Funds, Formation and Operation 2010 ("Breslow & Schwartz"), at § 2:5.6 (discussing the various remedies that may be imposed in the event an investor fails to fund its contractual capital commitment, including, but not limited to, "the ability to draw additional capital from non-defaulting

are subject to investment restrictions, and, during the initial years of a fund, calculate fees payable to an adviser as a percentage of the total capital commitments of investors, regardless of whether or not the capital commitment is ultimately fully funded by an investor.[242] Venture capital fund advisers typically report and market themselves to investors on the basis of aggregate capital commitment amounts raised for prior or existing funds.[243] These factors would lead to the conclusion that, in contrast to other types of private funds, such as hedge funds, which trade on a more frequent basis, a venture capital fund would view the fund's total capital commitments as the primary metric for managing the fund's assets and for determining compliance with investment guidelines. Hence, we believe that calculating the leverage threshold to include uncalled capital commitments is appropriate, given that capital commitments are already used by venture capital funds themselves to measure investment guideline compliance.

Thus, we are retaining the 15 percent leverage threshold, as proposed, so that a qualifying fund could only incur debt (or provide guarantees of portfolio company obligations) subject to this threshold. However, we are modifying the leverage criterion to exclude from the 120-

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investors;" "the right to force a sale of the defaulting partner's interests at a price determined by the general partner;" and "the right to take any other action permitted at law or in equity").

242 *See, e.g.*, Breslow & Schwartz, *supra* note 241, at § 2:5.7 (noting that a cap of 10% to 25% of remaining capital commitments is a common limitation for follow-on investments). *See also* Schell, *supra* note 185, at §1.01 (noting that capital contributions made by the investors are used to "make investments . . . in a manner consistent with the investment strategy or guidelines established for the Fund."); *id*. at §1.03 ("Management fees in a Venture Capital Fund are usually an annual amount equal to a fixed percentage of total Capital Commitments."); *see also* Dow Jones, *Private Equity Partnership Terms and Conditions*, 2007 edition ("Dow Jones Report") at 15.

243 *See, e.g.*, NVCA Yearbook 2010, *supra* note 150, at 16; John Jannarone, *Private Equity's Cash Problem*, Wall St. J., June 23, 2010, http://online.wsj.com/article/SB10001424052748704853404575323073059041024.html#printMode.

calendar day limit any guarantee of qualifying portfolio company obligations by the qualifying fund, up to the value of the fund's investment in the qualifying portfolio company.[244] Commenters generally argued in favor of extending the period during which a qualifying fund's leverage could remain outstanding. Some recommended extending the 120-day limit with respect to leverage to 180 days with one 180-day renewal in the case of non-convertible bridge loans extended by the venture capital fund to a portfolio company.[245] Others seeking to accommodate business practices and provide maximum flexibility for venture capital fund debt investments in portfolio companies recommended excluding guarantees of portfolio company debt by a venture capital fund from the 120-day limit.[246] Other commenters argued that guarantees of portfolio company obligations would not result in qualifying funds incurring extensive leverage.[247]

We understand that guarantees of portfolio company leverage by a venture capital fund are typically limited to the value of the fund's investment in the company (often through a pledge of the fund's interest in the company).[248] Such guarantees by a qualifying fund may help a qualifying portfolio company obtain credit for working capital purposes, rather than be used by the fund to leverage its investment in the company.[249] We are persuaded that such guarantees of portfolio company indebtedness do not present the same types of risks identified by Congress. Congress cited the implementation of trading strategies that use financial leverage by certain

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244 Rule 203(l)-1)(a)(3).

245 *See, e.g.,* NVCA Letter; Davis Polk Letter; Bessemer Letter.

246 Cook Children's Letter; Leland Fikes Letter; Gunderson Dettmer Letter; Oak Investment Letter; SVB Letter. *See also* ABA Letter.

247 *See, e.g.*, SVB Letter.

248 *See also* NVCA Letter.

249 *See, e.g.*, Oak Investments Letter; SVB Letter.

private funds as creating a potential for systemic risk.[250] In testimony before Congress, the venture capital industry identified the lack of financial leverage in venture capital funds as a basis for exempting advisers to venture capital funds[251] in contrast with other types of private funds such as hedge funds, which may engage in trading strategies that may contribute to systemic risk and affect the public securities markets.[252] For this reason, our proposed rule was designed to address concerns that financial leverage may contribute to systemic risk by excluding funds that incur more than a limited amount of leverage from the definition of venture capital fund.[253] We believe that the alternative approach to fund leverage we have adopted in the final rule better reflects industry practice while still addressing Congress' concern that the use of financial leverage may create the potential for systemic risk.

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[250] *See* Proposing Release, *supra* note 26, at n.136 and accompanying text.

[251] *See* McGuire Testimony, *supra* note 151, at 7 ("Venture capital firms do not use long term leverage, rely on short term funding, or create third party or counterparty risk . . . . [F]rom previous testimony submitted by the buy-out industry, the typical capital structure of the companies acquired by a buyout fund is approximately 60% debt and 40% equity. In contrast, borrowing at the venture capital fund level, if done at all, typically is only used for short-term capital needs (pending drawdown of capital from its partners) and does not exceed 90 days. Not only are our partnerships run without debt but our portfolio companies are usually run without debt as well."); Loy Testimony, *supra* note 151, at 2 ("Although venture capital funds may occasionally borrow on a short-term basis immediately preceding the time when the cash installments are due, they do not use debt to make investments in excess of the partner's capital commitments or 'lever up' the fund in a manner that would expose the fund to losses in excess of the committed capital or that would result in losses to counter parties requiring a rescue infusion from the government.").

[252] *See* S. Rep. No. 111-176, *supra* note 6, at 74-75.

[253] In proposing an exemption for advisers to private equity funds, which would have required the Commission to define the term "private equity fund," the Senate Banking Committee noted the difficulties in distinguishing some private equity funds from hedge funds and expected the Commission to exclude from the exemption private equity funds that raise significant potential systemic risk concerns. S. Rep. No. 111-176, *supra* note 6, at 75. *See also* G20 Working Group 1, Enhancing Sound Regulation and Strengthening Transparency, at 7 (March 25, 2009) (noting that unregulated entities such as hedge funds may contribute to systemic risks through their trading activities).

6. No Redemption Rights

We are adopting as proposed the definitional element under which a venture capital fund is a private fund that issues securities that do not provide investors redemption rights except in "extraordinary circumstances" but that entitle investors generally to receive *pro rata* distributions.[254] Unlike hedge funds, a venture capital fund does not typically permit investors to redeem their interests during the life of the fund,[255] but rather distributes assets generally as investments mature.[256]

Although venture capital funds typically return capital and profits to investors only through *pro rata* distributions, such funds may also provide extraordinary rights for an investor to withdraw from the fund under foreseeable but unexpected circumstances or to be excluded from particular investments due to regulatory or other legal requirements.[257] These events may

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254 Rule 203(l)-1(a)(4).

255 *See* Schell, *supra* note 185, at §1.03[7] (venture capital fund "redemptions and withdrawals are rarely allowed, except in the case of legal compulsion"); Breslow & Schwartz, *supra* note 241, at §2:14.2 ("the right to withdraw from the fund is typically provided only as a last resort").

256 Loy Testimony, *supra* note 151, at 2-3 ("As portfolio company investments are sold in the later years of the [venture capital] fund–when the company has grown so that it can access the public markets through an initial public offering (an IPO) or when it is an attractive target to be bought–the liquidity from these 'exits' is distributed back to the limited partners. The timing of these distributions is subject to the discretion of the general partner, and limited partners may not otherwise withdraw capital during the life of the venture [capital] fund."). *Id.* at 5 (Investors "make their investment in a venture [capital] fund with the full knowledge that they generally cannot withdraw their money or change their commitment to provide funds. Essentially they agree to 'lock-up' their money for the life of the fund, generally 10 or more years as I stated earlier."). *See also* Dow Jones Report, *supra* note 242, at 60 (noting that an investor in a private equity or venture capital fund typically does not have the right to transfer its interest). *See generally* Proposing Release, *supra* note 26, section II.A.4.

257 *See* Hedge Fund Adviser Registration Release, *supra* note 14, at n.240 and accompanying text ("Many partnership agreements provide the investor the opportunity to redeem part or all of its investment, for example, in the event continuing to hold the investment became impractical or illegal, in the event of an owner's death or total disability, in the event key personnel at the fund adviser die, become incapacitated, or cease to be involved in the management of the fund for an extended period of time, in the event of a merger or reorganization of the fund, or in order to avoid a materially adverse tax or regulatory outcome. Similarly, some investment pools may

be "foreseeable" because they are circumstances that are known to occur (*e.g.*, changes in law, corporate events such as mergers, *etc.*) but are unexpected in their timing or scope. Thus, withdrawal, exclusion or similar "opt-out" rights would be deemed "extraordinary circumstances" if they are triggered by a material change in the tax law after an investor invests in the fund, or the enactment of laws that may prohibit an investor's participation in the fund's investment in particular countries or industries.[258] The trigger events for these rights are typically beyond the control of the adviser and fund investor (*e.g.*, tax and regulatory changes).

Most commenters addressing the redeemability criterion did not oppose it, but rather sought clarification or guidance on the scope of its application.[259] For example, commenters specifically requested confirmation that the lack of redeemability criterion would not preclude a

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offer redemption rights that can be exercised only in order to keep the pool's assets from being considered 'plan assets' under ERISA [Employee Retirement Income Security Act of 1974]."). *See, e.g.*, Breslow & Schwartz, *supra* note 241, at § 2:14.1 ("Private equity funds generally provide for mandatory withdrawal of a limited partner [*i.e.*, investor] only in the case where the continued participation by a limited partner in a fund would give rise to a regulatory or legal violation by the investor or the fund (or the general partner [*i.e.*, adviser] and its affiliates). Even then, it is often possible to address the regulatory issue by excusing the investor from particular investments while leaving them otherwise in the fund.").

258 *See, e.g.*, Breslow & Schwartz, *supra* note 241, at § 2:14.2 ("The most common reason for allowing withdrawals from private equity funds arises in the case of an ERISA violation where there is a substantial likelihood that the assets of the fund would be treated as 'plan assets' of any ERISA partner for purposes of Title I of ERISA or section 4975 of the Code."). *See also* Schell, *supra* note 185, at §9.04[3] ("Exclusion provisions allow the General Partner to exclude a Limited Partner from participation in any or all investments if a violation of law or another material adverse effect would otherwise occur."); *id.* at Appendix D-31 (attaching model limited partnership agreement providing "The General Partner at any time may cancel the obligations of all Partners to make Capital Contributions for Portfolio Instruments if . . . changes in applicable law . . . make such cancellation necessary or advisable . . .").

259 A number of commenters agreed with the redeemability criterion. *See, e.g.*, ATV Letter; Charles River Letter; Gunderson Dettmer Letter. However, one commenter argued that a fund's redeemability is not necessarily characteristic of venture capital funds. Comment Letter of Cooley LLP (Jan. 21, 2011).

qualifying fund from (i) making distributions of carried interest to a general partner,[260] (ii) specifying redemption rights for certain categories of investors under certain circumstances[261] or (iii) specifying opt-out rights for investors.[262] Several commenters, however, indicated that the term "extraordinary circumstances" is sufficiently clear,[263] suggesting that the proposal did not require further clarification.

We believe that the term "extraordinary circumstances" is sufficiently clear. Whether or not specific redemption or "opt out" rights for certain categories of investors under certain circumstances should be treated as "extraordinary" will depend on the particular facts and circumstances.

For these purposes, for example, a fund that permits quarterly or other periodic withdrawals would be considered to have granted investors redemption rights in the ordinary course even if those rights may be subject to an initial lock-up or suspension or restrictions on redemption. We believe, and several commenters confirmed, that the phrase "extraordinary circumstances" is sufficiently clear to distinguish the terms for investor liquidity of venture capital funds, as they operate today, from hedge funds.[264] Congressional testimony cited an investor's inability to withdraw from a venture capital fund as a key characteristic of venture

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260 *See, e.g.,* NVCA Letter. The rule specifies that a qualifying fund is a private fund that "issues securities the terms of which do not provide a holder with any right, except in extraordinary circumstances, to withdraw . . ." If a general partner interest is not a "security," then the redeemability criterion of the rule would not be implicated. Whether or not a general partner interest is a "security" depends on the particular facts and circumstances. *See generally Williamson v. Tucker*, 645 F.2d 404 (5th Cir. 1981), *cert. denied*, 454 U.S. 897 (1981).

261 ABA Letter (sought guidance on whether granting redemption rights to certain types of investors such as ERISA funds and state plans, in the event of certain ERISA, tax or regulatory changes would be considered extraordinary).

262 McGuireWoods Letter.

263 *See* Gunderson Dettmer Letter; Merkl Letter; SVB Letter.

264 *See, e.g., id.*

capital funds and a factor for reducing their potential for systemic risk.[265] Although a fund prohibiting redemptions would satisfy the redeemability criterion of the venture capital fund definition, the rule does not specify a minimum period of time for an investor to remain in the fund.

In the Proposing Release, we expressed the general concern that a venture capital fund might seek to circumvent the intended scope of this criterion by providing investors with nominally "extraordinary" rights to redeem that effectively result in *de facto* redemption rights in the ordinary course.[266] One commenter expressly disagreed with this view, asserting that in the case of transfers effected with the consent of a general partner, such transactions are intended to accommodate an investor's internal corporate restructurings, bankruptcies or portfolio allocations rather than to provide investors with liquidity from the fund.[267] While consents to transfer do not raise the same level of concern as *de facto* redemption rights, we do not believe that an adviser or its related persons could, while relying on the venture capital exemption, create *de facto* periodic redemption or transfer rights by, for example, regularly identifying potential investors on behalf of fund investors seeking to transfer or redeem fund interests.[268]

We are not modifying the rule to include additional conditions for fund redemptions, such

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265 *See supra* notes 255-256 and accompanying text.

266 For example, in the Proposing Release, we stated that a private fund's governing documents might provide that investors do not have any right to redeem without the consent of the general partner. In practice, if the general partner typically permits investors to redeem their otherwise non-redeemable interests on a periodic basis, then the fund would not be considered to have issued securities that "do not provide a holder with any right, except in extraordinary circumstances, to withdraw." Rule 203(l)-1(a)(4). *See* Proposing Release, *supra* note 26, at n.154.

267 *See* NVCA Letter (disagreeing with statements in the Proposing Release regarding the *de facto* creation of redemption rights but generally agreeing with the general prohibition on redemptions except in extraordinary circumstances).

268 Section 208(d) of the Advisers Act.

as specifying a minimum holding or investment period by investors or a maximum amount that may be redeemed at any time. Commenters generally did not support the imposition of such conditions,[269] and we agree that imposing such conditions would not appear to be necessary to achieve the purposes of the rule.

7. Represents Itself as Pursuing a Venture Capital Strategy

Under the rule, a qualifying fund must represent itself as pursuing a venture capital strategy to its investors and potential investors.[270] Without this element, a fund that did not engage in typical venture capital activities could be treated as a venture capital fund simply because it met the other elements specified in our rule (because for example it only invests in short-term holdings, does not borrow, does not offer investors redemption rights, and is not a registered investment company).[271] We believe that only funds that do not significantly differ from the common understanding of what a venture capital fund is,[272] and that are actually offered to investors as funds that pursue a venture capital strategy, should qualify for the exemption. Thus, for example, an adviser to a venture capital fund that is otherwise relying on the exemption could not (i) identify the fund as a hedge fund or multi-strategy fund (*i.e.*, venture capital is one of several strategies used to manage the fund) or (ii) include the fund in a hedge fund database or hedge fund index.

As proposed, rule 203(l)-1 defined a venture capital fund as a private fund that

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269 *See, e.g.*, SVB Letter (expressing opposition to a rule that would limit redemptions following a minimum investment period or limit redemptions to a specified maximum threshold).

270 Rule 203(1)-1(a)(1).

271 We also note that a fund that represents to investors that it is one type of fund while pursuing a different type of fund strategy may raise concerns under rule 206(4)-8 of the Advisers Act.

272 *See* Proposing Release, *supra* note 26, at n.157.

"represents itself as being a venture capital fund to its investors and potential investors."[273] Although several commenters generally supported the "holding out" criterion as proposed,[274] many sought confirmation that the use of specific self-identifying terminology by a fund in its name (*e.g.*, "private equity" fund, "multi-strategy" fund or "growth capital" fund) would not automatically disqualify the fund under the definition.[275] Several commenters argued that historically, some funds have avoided referring to themselves as "venture capital funds."[276] One commenter argued that the proposed condition was too restrictive because it focuses on the fund's name rather than its investment strategy and suggested that the definition instead exclude any fund that markets itself as a hedge fund, multi-strategy fund, buyout fund or fund of funds.[277]

We believe that the "holding out" criterion remains an important distinction between funds that are eligible to rely on the definition and funds that are not, because an investor's understanding of the fund and its investment strategy must be consistent with an adviser's reliance on the exemption. However, we also recognize that it is not necessary (nor indeed sufficient) for a qualifying fund to name itself as a "venture capital fund" in order for its adviser to rely on the venture capital exemption. Hence, we are modifying the proposed definition to refer to the way a qualifying fund describes its investment strategy to investors and prospective investors.

A qualifying fund name that does not use the words "venture capital" and is not inconsistent with pursuing a venture capital strategy would not preclude a qualifying fund from

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273 Proposed Rule 203(l)-1(a)(1).

274 *See* Gunderson Dettmer Letter; Sen. Levin Letter; Merkl Letter.

275 *See*, *e.g.*, IVP Letter; Comment Letter of MissionPoint Capital Partners, Jan. 24, 2011; PEI Funds Letter.

276 *See*, *e.g.*, NVCA Letter; Pine Brook Letter. *See also* IVP Letter; PEI Funds Letter.

277 *See* Pine Brook Letter.

satisfying the definition.[278] Whether or not a fund represents itself as pursuing a venture capital strategy, however, will depend on the particular facts and circumstances. Statements made by a fund to its investors and prospective investors, not just what the fund calls itself, are important to an investor's understanding of the fund and its investment strategy.[279] The appropriate framework for analyzing whether a qualifying fund has satisfied the holding out criterion depends on all of the statements (and omissions) made by the fund to its investors and prospective investors. While this includes the fund name, it is only part of the analysis.

This approach is similar to our general approach to antifraud provisions under the federal securities laws, including Advisers Act rule 206(4)-8 regarding pooled investment vehicles.[280] The general antifraud rule under rule 206(4)-8 looks to the private fund's statements and omissions in light of the circumstances under which such statements or omissions are made.[281] Similarly, the holding out criterion under our venture capital fund definition looks to all of the relevant statements made by the qualifying fund regarding its investment strategy.

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278 Similarly, misleadingly including the words "venture capital" in the name of a fund pursuing a different strategy would not satisfy the definition.

279 One commenter requested confirmation and examples of what constituted appropriate representations to investors given that "many" venture capital funds do not use private placement memoranda or other offering materials during fundraising. *See* Gunderson Dettmer Letter (expressed the view that the following would be sufficient: (i) checking the "venture capital" box on Form D or (ii) stating on the adviser's website that all of the funds advised by the adviser are venture capital funds). As we noted above, whether or not a venture capital fund satisfies the "holding out" criterion will depend on the particular facts and circumstances surrounding all of the statements and omissions made by the fund in light of the circumstances under which they were made. Moreover, a venture capital fund that seeks to rely on the safe harbor for non-public offerings under rule 506 of Regulation D is subject to all of the conditions of such rule, including the prohibition on general solicitation and general advertising applicable to statements attributable to the fund on a publicly available website. *See* 17 CFR 230.502(c).

280 17 CFR 275.206(4)-8.

281 *See* Pooled Vehicles Release, *supra* note 122, at n.27 ("A fact is material if there is a substantial likelihood that a reasonable investor in making an investment decision would consider it as having significantly altered the total mix of information available," citing *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988)).

8. Is a Private Fund

We define a venture capital fund for purposes of the exemption as a private fund, which is defined in the Advisers Act, and exclude from the definition funds that are registered investment companies (*e.g.*, mutual funds) or have elected to be regulated as BDCs.[282] We are adopting this provision as proposed.

There is no indication that Congress intended the venture capital exemption to apply to advisers to these publicly available funds,[283] referring to venture capital funds as a "subset of private investment funds."[284] The comment letters that addressed this proposed criterion generally supported it.[285]

9. Application to Non-U.S. Advisers

The final rule does not define a venture capital fund as a fund advised by a U.S. adviser (*i.e.*, an adviser with a principal office and place of business the United States). Thus, a non-U.S. adviser, as well as a U.S. adviser, may rely on the venture capital exemption provided that such adviser solely advises venture capital funds that satisfy all of the elements of the rule or satisfy the grandfathering provision (discussed in greater detail below). A non-U.S. adviser may rely on the venture capital exemption if all of its clients, whether U.S. or non-U.S., are venture capital funds.

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282 Rule 203(l)-1(a) and (a)(5). *See also* discussion *infra* note 319.

283 Legislative history does not indicate that Congress addressed this matter, nor does testimony before Congress suggest that this was contemplated. *See, e.g.*, McGuire Testimony, *supra* note 151, at 3 (noting that venture capital funds are not directly accessible by individual investors); Loy Testimony, *supra* note 151, at 2 ("Generally . . . capital for the venture fund is provided by qualified institutional investors such as pension funds, universities and endowments, private foundations, and to a lesser extent, high net worth individuals."). *See generally* section 202(a)(29) of the Advisers Act (definition of "private fund").

284 *See* S. Rep. No. 111-176, *supra* note 6, at 74 (describing venture capital funds as a subset of "private investment funds").

285 Gunderson Dettmer Letter; Merkl Letter; NYSBA Letter; Sen. Levin Letter.

Neither the statutory text of section 203(l) nor the legislative reports provide an indication of whether Congress intended the exemption to be available to advisers that operate principally outside of the United States but that invest in U.S. companies or solicit U.S. investors.[286] Testimony before Congress presented by members of the U.S. venture capital industry discussed the industry's role primarily in the U.S. economy including its lack of interconnection with the U.S. financial markets and "interdependence" with the world financial system.[287] Nevertheless, we expect that venture capital funds with advisers operating principally outside of the United States may seek to access the U.S. capital markets by investing in U.S. companies or soliciting U.S. investors; investors in the United States may also have an interest in venture capital opportunities outside of the United States.

Commenters generally did not support defining venture capital fund or qualifying portfolio company by reference to the jurisdiction of formation of the fund or portfolio company.[288] Several commenters, however, supported modifying the rule to apply the venture capital exemption in the same manner as the proposed private fund adviser exemption, with the result that a non-U.S. adviser could disregard its non-U.S. activities when assessing eligibility for the venture capital exemption.[289] Under this approach, only U.S.-domiciled private funds would

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[286] *See* section 203(l) of the Advisers Act; H. Rep. No. 111-517, *supra* note 6, at 867; S. Rep. No. 111-176, *supra* note 6, at 74-75.

[287] *See* Loy Testimony, *supra* note 151, at 4-5; McGuire Testimony, *supra* note 151, at 5-6.

[288] *See, e.g.,* Bessemer Letter; EVCA Letter; McDonald Letter; Merkl Letter; NVCA Letter; SV Life Sciences Letter.

[289] *See* McGuireWoods Letter; Shearman Letter. *See also* EFAMA Letter (also noting that as a practical matter, the rule should account for non-U.S. specific practices so that non-U.S. advisers could rely on the exemption); Gunderson Dettmer Letter (exemption should be available to non-U.S. advisers even if non-U.S. funds do not satisfy definitional elements); Dechert General Letter (non-U.S. advisers that manage funds that are not venture capital funds outside of the U.S. should be able to rely on rule 203(l) for funds that are managed in the U.S. or that are marketed to U.S. investors).

be required to satisfy our definition of a venture capital fund in order for the adviser to rely on the venture capital exemption.[290] One commenter suggested that the same policy rationale underlying the private fund adviser exemption justified this approach to the venture capital exemption.[291] Two other commenters supported this approach arguing that non-U.S. funds may operate in a manner that does not resemble venture capital fund investing in the United States or by U.S. venture capital fund advisers.[292]

We do not agree that the private fund adviser exemption is the appropriate framework for the venture capital exemption in the case of non-U.S. advisers. Section 203(l) provides an exemption for an investment adviser based on the strategy of the funds that the adviser manages (*i.e.*, venture capital funds). This exemption thus specifies the activities in which an adviser's clients may engage, and does not refer to activities in the United States.[293] By contrast, section 203(m) is based upon the location where the advisory activity is conducted. Accordingly, we do not believe it would be appropriate for an adviser relying on section 203(l) to disregard its non-U.S. activities. Moreover, a non-U.S. adviser could circumvent the intended scope of the exemption by merely sponsoring and advising solely non-U.S. domiciled funds that are not venture capital funds.

Under our rule, only a private fund may qualify as a venture capital fund. As we noted in the Proposing Release, a non-U.S. fund that uses U.S. jurisdictional means in the offering of the securities it issues and that relies on section 3(c)(1) or 3(c)(7) of the Investment Company Act

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290 *See* EFAMA Letter (certain conditions of the proposed rule, such as the limitation on cash investments to U.S. Treasuries, are inconsistent with practices outside the United States). We believe that these concerns are adequately addressed by the non-qualifying basket.

291 *See* Shearman Letter.

292 *See* EFAMA Letter; McGuireWoods Letter.

293 *See also infra* note 322 and accompanying and following text.

would be a private fund.[294] A non-U.S. fund that does not use U.S. jurisdictional means to conduct an offering would not be a private fund and therefore could not qualify as a venture capital fund, even if it operated as a venture capital fund in a manner that would otherwise meet the criteria under our definition.[295] As a result, under the proposed rule, if a non-U.S. fund did not qualify as a venture capital fund, then the fund's adviser would not be able to rely on the exemption.[296]

In light of this result, we asked in the Proposing Release whether we should adopt a broader interpretation of the term "private fund."[297] In response, commenters supported making the venture capital exemption available to non-U.S. advisers even if they advise venture capital

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294 An issuer that is organized under the laws of the United States or of a state is a private fund if it is excluded from the definition of an investment company for most purposes under the Investment Company Act pursuant to section 3(c)(1) or 3(c)(7). Section 7(d) of the Investment Company Act prohibits a non-U.S. fund from using U.S. jurisdictional means to make a public offering, absent an order permitting registration. A non-U.S. fund may conduct a private U.S. offering in the United States without violating section 7(d) only if the fund complies with either section 3(c)(1) or 3(c)(7) with respect to its U.S. investors (or some other available exemption or exclusion). Consistent with this view, a non-U.S. fund is a private fund if it makes use of U.S. jurisdictional means to, directly or indirectly, offer or sell any security of which it is the issuer and relies on either section 3(c)(1) or 3(c)(7). *See* Hedge Fund Adviser Registration Release, *supra* note 14, at n.226; *Offer and Sale of Securities to Canadian Tax-Deferred Retirement Savings Accounts*, Securities Act Release No. 7656 (Mar. 19, 1999) [64 FR 14648 (Mar. 26, 1999)] ("Canadian Tax-Deferred Retirement Savings Accounts Release"), at nn.10, 20, 23; *Statement of the Commission Regarding Use of Internet Web Sites to Offer Securities, Solicit Securities Transactions or Advertise Investment Services Offshore*, Securities Act Release No. 7516 (Mar. 23, 1998) [63 FR 14806 (Mar. 27, 1998)], at n.41. *See also* Dechert LLP, SEC Staff No-Action Letter (Aug. 24, 2009) at n.8; Goodwin, Procter & Hoar LLP, SEC Staff No-Action Letter (Feb. 28, 1997) ("Goodwin Procter No-Action Letter"); Touche Remnant & Co., SEC Staff No-Action Letter (Aug. 27, 1984) ("Touche Remnant No-Action Letter"); Proposing Release, *supra* note 26, at n.175 and accompanying text.

295 *See* Proposing Release, *supra* note 26, at nn.175 and 188 and accompanying text.

296 Under the Advisers Act, an adviser relying on the venture capital exemption must "solely" advise venture capital funds and under our rule all of the funds advised by the adviser must be private funds.

297 *See* Proposing Release, *supra* note 26, at section II.A.8 ("[S]hould a non-U.S. fund be a private fund under the proposed rule if the non-U.S. fund would be deemed a private fund upon conducting a private offering in the United States in reliance on sections 3(c)(1) or 3(c)(7)?").

funds that are not offered through the use of U.S. jurisdictional means.[298] We agree. Accordingly, as adopted, rule 203(l)-1 contains a note indicating that an adviser may treat as a "private fund"—and thus a venture capital fund, if it meets the rule's other criteria—any non-U.S. fund that is not offered through the use of U.S. jurisdictional means but that would be a private fund if the issuer were to conduct a private offering in the United States.[299] Moreover, a non-U.S. fund that is treated as a private fund under these circumstances by an adviser relying on the venture capital exemption would also be treated as a private fund under the Advisers Act for all purposes. This element is designed to ensure that an adviser relying on the venture capital exemption by operation of the note is subject to the same Advisers Act requirements as other advisers relying on the venture capital exemption without use of the note.

10. Grandfathering Provision

Under the rule, the definition of "venture capital fund" includes any private fund that: (i) represented to investors and potential investors at the time the fund offered its securities that it pursues a venture capital strategy; (ii) has sold securities to one or more investors prior to December 31, 2010; and (iii) does not sell any securities to, including accepting any capital commitments from, any person after July 21, 2011 (the "grandfathering provision").[300] A grandfathered fund would thus include any fund that has accepted all capital commitments by July 21, 2011 (including capital commitments from existing and new investors) even if none of

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[298] *See, e.g.*, Dechert General Letter; EFAMA Letter; Gunderson Dettmer Letter; McGuireWoods Letter; Shearman Letter.

[299] As discussed below, this issue also is relevant to the exemption provided by rule 203(m)-1. *See also infra* note 319.

[300] Rule 203(l)-1(b).

the capital commitments has been called by such date.[301] The calling of capital after July 21, 2011 would be consistent with the grandfathering provision, as long as the investor became obligated by July 21, 2011 to make a future capital contribution. As a result, any investment adviser that solely advises private funds that meet the definition in either rule 203(l)-1(a) or (b) would be exempt from registration.

Although several commenters expressed support for the proposed rule,[302] two commenters indicated that the proposed grandfathering provision was too restrictive because of the holding out criterion.[303] In contrast, the North American Securities Administrators Association, Inc. expressed its view that the proposed grandfathering provision was too expansive and urged that the rule impose additional substantive requirements similar to those included among the definitional elements in rule 203(l)-1(a).[304]

As in the case of the holding out criterion discussed above, this element of the grandfathering provision elicited the most comments. Generally, commenters either (i) did not support a grandfathering provision that defined a venture capital fund as a fund that identified itself (or called itself) "venture capital,"[305] or (ii) sought clarification or an expansive interpretation of the holding out element so that existing funds would not be excluded from the

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301 *See also Electronic Filing and Revision of Form D*, Securities Act Release No. 8891(Feb. 6, 2008) [73 FR 10592 (Feb. 27, 2008)], at section VIII, Form D, General Instructions – When to File (noting that a Form D is required to be filed within 15 days of the first sale of securities which would include "the date on which the first investor is irrevocably contractually committed to invest"), n.159 ("a mandatory capital commitment call would not constitute a new offering, but would be made under the original offering").

302 Comment Letter of AustinVentures (Jan. 21, 2011) ("AV Letter"); Norwest Letter; NYSBA Letter. *See also* NVCA Letter.

303 DLA Piper VC Letter; Pine Brook Letter.

304 Comment Letter of North American Securities Administrators Association, Inc., Feb. 10, 2011 ("NASAA Letter").

305 Davis Polk Letter; DLA Piper VC Letter; Pine Brook Letter.

definition merely because they have identified themselves as "growth capital," "multi-strategy" or "private equity,"[306] which commenters asserted is typical of some older funds. No commenter addressed the dates proposed in the grandfathering provision.[307]

As discussed above, we believe that the "holding out" requirement is an important prophylactic tool to prevent circumvention of the intended scope of the venture capital exemption. Thus, we are adopting the grandfathering provision as proposed, with the modifications to the holding out criterion discussed above.[308] As noted above in the definition of a venture capital fund generally, the holding out criterion in the grandfathering provision has also been changed to refer to the strategy pursued by the private fund. A fund that seeks to qualify under our rule should examine all of the statements and representations made to investors and prospective investors to determine whether the fund has satisfied the "holding out" criterion as it is incorporated into the grandfathering provision.[309]

Thus, under the rule, an investment adviser may treat any existing private fund as a venture capital fund for purposes of section 203(l) of the Advisers Act if the fund meets the elements of the grandfathering provision. The current private adviser exemption does not require an adviser to identify or characterize itself as any type of adviser (or impose limits on advising any type of fund). Accordingly, we believe that advisers have not had an incentive to mis-characterize the investment strategies pursued by existing venture capital funds that have already

306 Davis Polk Letter; Gunderson Dettmer Letter; IVP Letter; Norwest Letter; NVCA Letter.

307 The NVCA specifically stated that other than clarification on the names that venture capital funds may use to identify themselves, no "further changes to the grandfathering proposal are necessary or appropriate and [we] do not believe that this criterion, as it exists for new funds, presents problems to the industry." *See* NVCA Letter.

308 *See supra* discussion at Section II.A.7.

309 *Id*.

been marketed to investors. As we note above, a fund that "represents" itself to investors as pursuing a venture capital strategy is typically one that discloses it pursues a venture capital strategy and identifies itself as such.[310] We do not expect existing funds identifying themselves as pursuing a "private equity" or "hedge" fund strategy would be able to rely on this element of the grandfathering provision.

We believe that most funds previously sold as venture capital funds likely would satisfy all or most of the conditions in the grandfathering provision. Nevertheless, we recognize that investment advisers that sponsored new funds before the adoption of rule 203(l)-1 faced uncertainty regarding the precise terms of the definition and hence uncertainty regarding their eligibility for the new exemption. Thus, as proposed, the grandfathering provision specifies that a qualifying fund must have commenced its offering (*i.e.*, initially sold securities) by December 2010 and must have concluded its offering by the effective date of Title IV (*i.e.*, July 21, 2011). This provision is designed to prevent circumvention of the intended scope of the exemption. Moreover, requiring existing venture capital funds to modify their investment conditions or characteristics, liquidate portfolio company holdings or alter the rights of investors in the funds in order to satisfy the definition of a venture capital fund would likely be impossible in many cases and yield unintended consequences for the funds and their investors.[311]

B. Exemption for Investment Advisers Solely to Private Funds With Less Than $150 Million in Assets Under Management

Section 203(m) of the Advisers Act directs the Commission to exempt from registration under the Advisers Act any investment adviser solely to private funds that has less than $150

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310 *See id.*

311 One commenter agreed that it may be difficult for a qualifying fund seeking to rely on the grandfathering provision to change fund terms and liquidate its positions to the possible detriment of the fund and its investors. AV Letter.

million in assets under management in the United States.[312] Rule 203(m)-1, which we are adopting today, provides the exemption and, in addition, addresses several interpretive questions raised by section 203(m). As noted above, we refer to this exemption as the "private fund adviser exemption."

1. Advises Solely Private Funds

Rule 203(m)-1, like section 203(m), limits an adviser relying on the exemption to those advising "private funds" as that term is defined in the Advisers Act.[313] An adviser that has one or more clients that are not private funds is not eligible for the exemption and must register under the Advisers Act unless another exemption is available. An adviser may advise an unlimited number of private funds, provided the aggregate value of the assets of the private funds is less than $150 million.[314]

In the case of an adviser with a principal office and place of business outside of the United States (a "non-U.S. adviser"), the exemption is available as long as *all* of the adviser's clients that are United States persons are qualifying private funds.[315] As a consequence, a non-

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312 Section 408 of the Dodd-Frank Act, which is codified in section 203(m) of the Advisers Act. *See supra* note 19.

313 *See* rule 203(m)-1(a) and (b). Section 202(a)(29) of the Advisers Act defines the term "private fund" as "an issuer that would be an investment company, as defined in section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a-3), but for section 3(c)(1) or 3(c)(7) of that Act." A "private fund" includes a private fund that invests in other private funds. *See also supra* note 294; Proposing Release, *supra* note 26, at n.175 and accompanying text.

314 We note, however, that depending on the facts and circumstances, we may view two or more separately formed advisory entities that each has less than $150 million in private fund assets under management as a single adviser for purposes of assessing the availability of exemptions from registration. *See infra* note 506. *See also* section 208(d), which prohibits a person from doing, indirectly or through or by another person, any act or thing which it would be unlawful for such person to do directly.

315 Rule 203(m)-1(b)(1). As discussed below, we also are adding a note to rule 203(m)-1 that clarifies that a client will not be considered a United States person if the client was not a United States person at the time of becoming a client. *See infra* note 403.

U.S. adviser may enter the U.S. market and take advantage of the exemption without regard to the type or number of its non-U.S. clients or the amount of assets it manages outside of the United States. Under the rule, a non-U.S. adviser would not lose the private fund adviser exemption as a result of the size or nature of its advisory or other business activities outside of the United States. The rule reflects our long-held view that non-U.S. activities of non-U.S. advisers are less likely to implicate U.S. regulatory interests and that this territorial approach is in keeping with general principles of international comity.[316] Commenters supported the proposed rule's treatment of non-U.S. advisers.[317]

Some commenters urged that the rule should also permit U.S. advisers relying on the exemption to advise other types of clients.[318] Section 203(m) directs us to provide an exemption

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316 These considerations have, for example, been incorporated in our rules permitting a non-U.S. adviser relying on the private adviser exemption to count only clients that are U.S. persons when determining whether it has 14 or fewer clients. Rule 203(b)(3)-1(b)(5) ("If you have your principal office and place of business outside the United States, you are not required to count clients that are not United States residents, but if your principal office and place of business is in the United States, you must count all clients."). *See infra* note 392. The Dodd-Frank Act repeals the private adviser exemption as of July 21, 2011, and we are rescinding rule 203(b)(3)-1 in the Implementing Adopting Release. *See* Implementing Adopting Release, *supra* note 32, at section II.D.2.a.

317 *See, e.g.*, ABA Letter; Comment Letter of Debevoise & Plimpton LLP (Jan. 24, 2011) ("Debevoise Letter"); Comment Letter of Dechert LLP (on behalf of Foreign Adviser) (Jan. 24, 2011) ("Dechert Foreign Adviser Letter"); Gunderson Dettmer Letter; Merkl Letter; Comment Letter of Katten Muchin Rosenman LLP (on behalf of Certain Non-U.S. Advisers) (Jan. 24, 2011) ("Katten Foreign Advisers Letter"); Comment Letter of MAp Airports Limited (Jan. 24, 2011) ("MAp Airports Letter"); Comment Letter of Wellington Financial LP (Jan. 24, 2011) ("Wellington Letter").

318 *See, e.g.*, Letter of Sadis & Goldberg (Jan. 11, 2011) (submitted in connection with the Implementing Proposing Release, avail. at http://www.sec.gov/comments/s7-36-10/s73610.shtml) ("Sadis & Goldberg Implementing Release Letter") (exemption should be available to advisers who, in addition to advising private funds, also have five or fewer clients that are separately managed accounts); Comment Letter of Seward & Kissel LLP (Jan. 31, 2011) ("Seward Letter") (advisers should be permitted to rely on multiple exemptions and advisers relying on the private fund adviser exemption should be permitted to engage in "some activities that do not involve advising clients and have no effect on assets under management," such as providing research to institutional investors).

to advisers that act *solely* as advisers to private funds.[319] Our treatment of non-U.S. advisers with respect to their non-U.S. clients, as we note above, establishes certain appropriate limits on the extraterritorial application of the Advisers Act.[320] In contrast, permitting U.S. advisers with additional types of clients to rely on the exemption would appear to directly conflict with section 203(m), and we therefore are not revising the rule as the commenters proposed.

Some commenters suggested that the rule permit advisers to combine other exemptions with rule 203(m)-1 so that, for example, an adviser could advise venture capital funds with assets under management in excess of $150 million in addition to other types of private funds with less than $150 million in assets under management.[321] We believe that the commenters' proposed interpretation runs contrary to the language of section 203(m), which limits advisers relying on the exemption to advising *solely* private funds with assets under management in the United States of less than $150 million or *solely* venture capital funds in the case of section 203(l).[322]

A few commenters also asked us to address whether a fund with a single investor could

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[319] One commenter argued that a U.S. adviser should be permitted to treat as a private fund for purposes of rule 203(m)-1 a non-U.S. fund that has not made an offering to U.S. persons. *See* Comment Letter of Fox Horan & Camerini LLP (Dec. 22, 2010). *See also supra* notes 294 and 313. We agree.

[320] In contrast to the foreign private adviser exemption discussed in Section II.C, a non-U.S. adviser relying on the private fund adviser exemption may have a U.S. place of business, but a non-U.S. adviser need not have a U.S. place of business to rely on the private fund adviser exemption.

[321] NASBIC/SBIA Letter; Seward Letter.

[322] The same analysis also would apply to non-U.S. advisers, which may not for example combine the private fund adviser exemption and the foreign private adviser exemption (*e.g.*, a non-U.S. adviser could not advise private funds that are United States persons with assets in excess of $25 million in reliance on the private fund adviser exemption and also advise other clients in the United States that are not private funds in reliance on the foreign private adviser exemption). We also note that depending on the facts and circumstances, we may view two or more separately formed advisory entities, each of which purports to rely on a separate exemption from registration, as a single adviser for purposes of assessing the availability of exemptions from registration. *See infra* note 506. *See also* section 208(d), which prohibits a person from doing, indirectly or through or by another person, any act or thing which it would be unlawful for such person to do directly.

be a "private fund" for purposes of the exemption.[323] Whether a single-investor fund could be a private fund for purposes of the exemption depends on the facts and circumstances. We are concerned that an adviser simply could convert client accounts to single-investor funds in order to avoid registering under the Advisers Act. These "funds" would be tantamount to separately managed accounts. Section 208(d) of the Advisers Act anticipates these and other artifices and thus prohibits a person from doing, indirectly or through or by another person, any act or thing which it would be unlawful for such person to do directly.[324] We recognize, however, that there are circumstances in which it may be appropriate for an adviser to treat a single-investor fund as a private fund for purposes of rule 203(m)-1.[325]

One commenter argued that advisers should be permitted to treat as a private fund for purposes of rule 203(m)-1 a fund that also qualifies for another exclusion from the definition of "investment company" in the Investment Company Act in addition to section 3(c)(1) or 3(c)(7),

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323 *See* ABA Letter (single-investor funds formed at the request of institutional investors should be considered private funds if they are managed in a manner similar to the adviser's related multi-investor private funds, have audited financial statements, and are treated as private funds for purposes of the custody rule); Comment Letter of Alternative Investment Management Association (Jan. 24, 2011) ("AIMA Letter") (sought guidance concerning single-investor funds and managed accounts structured as funds); Commenter Letter of Managed Funds Association (Jan. 24, 2011) ("MFA Letter") (asserted that single-investor funds are "private funds").

324 We would view a structure with no purpose other than circumvention of the Advisers Act as inconsistent with section 208(d). *See, e.g.*, *Custody of Funds or Securities of Clients by Investment Advisers*, Investment Advisers Act Release No. 2968 (Dec. 30, 2009) [75 FR 1456 (Jan. 11, 2010)] at n.132 (the use of a special purpose vehicle in certain circumstances could constitute a violation of section 208(d) of the Advisers Act). Thus, for example, an adviser would not be eligible for the exemption if it advises what is nominally a "private fund" but that in fact operates as a means for providing individualized investment advice directly to the investors in the "private fund." In this case, the investors would also be clients of the adviser. *Cf.* Advisers Act rule 202(a)(30)-1(b)(1) (an adviser "must count an owner [of a legal organization] as a client if [it] provide[s] investment advisory services to the owner separate and apart from the investment advisory services [it] provide[s] to the legal organization").

325 For example, a fund that seeks to raise capital from multiple investors but has only a single, initial investor for a period of time could be a private fund, as could a fund in which all but one of the investors have redeemed their interests.

such as section 3(c)(5)(C), which excludes certain real estate funds.[326] These funds would not be private funds, because a "private fund" is a fund that would be an investment company as defined in section 3 of the Investment Company Act *but for* section 3(c)(1) or 3(c)(7) of that Act.[327]

The commenter argued, and we agree, that an adviser should nonetheless be permitted to advise such a fund and still rely on the exemption. Otherwise, for example, an adviser to a section 3(c)(1) or 3(c)(7) fund would lose the exemption if the fund also qualified for another exclusion, even though the adviser may be unaware of the fund so qualifying and the fund does not purport to rely on the other exclusion. We do not believe that Congress intended that an adviser would lose the exemption in these circumstances. Accordingly, the definition of a "qualifying private fund" in rule 203(m)-1 permits an adviser to treat as a private fund for purposes of the exemption a fund that qualifies for an exclusion from the definition of investment company as defined in section 3 of the Investment Company Act in addition to the exclusions provided by section 3(c)(1) or 3(c)(7).[328]

An adviser relying on this provision must treat the fund as a private fund under the Advisers Act and the rules thereunder for all purposes.[329] This is to ensure that an adviser

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[326] Dechert General Letter. *See also* Comment Letter of Baker McKenzie LLP (Jan. 26, 2011) (submitted in connection with the Implementing Proposing Release, avail. at http://www.sec.gov/comments/s7-36-10/s73610.shtml) (recommended that the Commission revise the calculation of assets under management on Form ADV to exclude assets in certain funds relying on section 3(c)(5)(C) of the Investment Company Act); Comment Letter of DLA Piper LLP (US) (submitted by John H. Heuberger and Hal M. Brown) (similarly sought to exempt advisers to certain funds relying on section 3(c)(5)(C)).

[327] Section 202(a)(29) of the Advisers Act (defining the term "private fund").

[328] Rule 203(m)-1(d)(5). This provision may also apply to non-U.S. funds that seek to comply with section 7(d) of the Investment Company Act and exclusions in addition to those provided by section 3(c)(1) or 3(c)(7) of that Act.

[329] Rule 203(m)-1(d)(5).

relying on the exemption as a result of our modification of the definition of a "qualifying private fund" is subject to the same Advisers Act requirements as other advisers relying on the exemption. Therefore, an adviser to a fund that also qualifies for another exclusion in addition to section 3(c)(1) or 3(c)(7) may treat the fund as a private fund and rely on rule 203(m)-1 if the adviser meets the rule's other conditions, provided that the adviser treats the fund as a private fund under the Advisers Act and the rules thereunder for all purposes including, for example, reporting on Form ADV, which requires advisers to report certain information about the private funds they manage.[330]

2. Private Fund Assets

a. Method of Calculation

Under rule 203(m)-1, an adviser must aggregate the value of all assets of private funds it manages to determine if the adviser is below the $150 million threshold.[331] Rule 203(m)-1 requires advisers to calculate the value of private fund assets pursuant to instructions in Form ADV, which provide a uniform method of calculating assets under management for regulatory purposes under the Advisers Act.[332]

In the Implementing Adopting Release, we are revising the instructions to Form ADV to

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330 *See* Item 7.B of Form ADV, Part 1A.

331 Rule 203(m)-1(d)(4).

332 *See* rules 203(m)-1(a)(2); 203(m)-1(b)(2); 203(m)-1(d)(1) (defining "assets under management" to mean "regulatory assets under management" in item 5.F of Form ADV, Part 1A); 203(m)-1(d)(4) (defining "private fund assets" to mean the "assets under management" attributable to a "qualifying private fund"). In the case of a subadviser, an adviser must count only that portion of the private fund assets for which it has responsibility. *See* Form ADV: Instructions for Part 1A, instr. 5.b.(2) (explaining that, if an adviser provides continuous and regular supervisory or management services for only a portion of a securities portfolio, it should include only that portion of the securities portfolio for which it provides such services, and that an adviser should exclude, for example, the portion of an account under management by another person).

provide a uniform method to calculate assets under management for regulatory purposes, including determining eligibility for Commission, rather than state, registration; reporting assets under management for regulatory purposes on Form ADV; and determining eligibility for two of the new exemptions from registration under the Advisers Act discussed in this Release.[333] Under the revised Form ADV instructions, as relevant here, advisers must include in their calculations proprietary assets and assets managed without compensation as well as uncalled capital commitments.[334] In addition, an adviser must determine the amount of its private fund assets based on the market value of those assets, or the fair value of those assets where market value is unavailable,[335] and must calculate the assets on a gross basis, *i.e.*, without deducting liabilities, such as accrued fees and expenses or the amount of any borrowing.[336]

Use of this uniform method will, we believe, result in more consistent asset calculations and reporting across the industry and, therefore, in a more coherent application of the Advisers

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333 *See* Implementing Adopting Release, *supra* note 32, discussion at section II.A.3 (discussing the rationale underlying the new instructions for calculating assets under management for regulatory purposes).

334 *See* Form ADV: Instructions for Part 1A, instr. 5.b.(1), (4). Advisers also must include in their "regulatory assets under management" assets of non-U.S. clients. *See* Implementing Adopting Release, *supra* note 32, at n.76 (explaining that a domestic adviser dealing exclusively with non-U.S. clients must register with the Commission if it uses *any* U.S. jurisdictional means in connection with its advisory business unless the adviser qualifies for an exemption from registration or is prohibited from registering with the Commission). *See also infra* note 415.

335 This valuation requirement is described in terms similar to the definition of "value" in the Investment Company Act, which looks to market value when quotations are readily available and, if not, then to fair value. *See* Investment Company Act section 2(a)(41). *See also* Implementing Adopting Release, *supra* note 32, at n.91 and accompanying text. Other standards also may be expressed as requiring that a determination of fair value be based on market quotations where they are readily available. *Id.*

336 *See* Form ADV: Instructions for Part 1A, instr. 5.b.(2), (4). *See also* Implementing Adopting Release, *supra* note 32, discussion at section II.A.3.

Act's regulatory requirements and assessment of risk.[337] In addition, the uniform method of calculation is designed to ensure that, to the extent possible, advisers with similar amounts of assets under management will be treated similarly for regulatory purposes, including their ability to rely on the private fund adviser exemption and the foreign private adviser exemption, both of which refer to an adviser's assets under management.[338]

Many commenters expressed general support for a uniform method of calculating assets under management in order to maintain consistency for registration and risk assessment purposes.[339] The proposals to use fair value of private fund assets and to include uncalled capital commitments in private fund assets also received support.[340] As discussed below, however, a number of commenters disagreed with or sought changes to one or more of the elements of the proposed method of calculating assets under management for regulatory purposes set forth in

[337] *See* Proposing Release, *supra* note 26, discussion at section II.B.2. *See also* Implementing Adopting Release, *supra* note 32, discussion at section II.A.3.

[338] *See* Proposing Release, *supra* note 26, discussion at section V.B.1 (explaining that, because the instructions to Form ADV previously permitted advisers to exclude certain types of managed assets, "it is not possible to conclude that two advisers reporting the same amount of assets under management are necessarily comparable because either adviser may elect to exclude all or some portion of certain specified assets that it manages").

[339] *See*, *e.g.*, AFL-CIO Letter ("We support the SEC's proposal to require funds to use a uniform standard to calculate their assets under management and agree that it is important that the calculation account for asset appreciation."); AFR Letter ("AFR supports the SEC's proposal to require funds to use a uniform standard to calculate their assets under management, and to account for asset appreciation in those calculations"); AIMA Letter ("We agree that a clear and unified approach for calculation of AUM is necessary and we believe that using as a standard the assets for which an adviser has 'responsibility' is appropriate."); Dechert General Letter (commented on particular aspects of the proposed uniform method but stated "[w]e generally agree with the Commission's initiative in creating a single uniform method of calculating an adviser's assets under management ('AUM') for purposes of determining an adviser's registration status ('Regulatory AUM')"). *See also* Implementing Adopting Release, *supra* note 32, at n.68 and accompanying text.

[340] *See* ABA Letter (supported use of fair value); AIMA Letter (supported including uncalled capital commitments, provided that the adviser has full contractual rights to call that capital and would be given responsibility for management of those assets).

Form ADV.[341] None of the commenters, however, suggested alternative approaches that could accommodate the specific changes they sought and achieve our goals of consistent asset calculations and reporting discussed above, and we are not aware of such an alternative approach.

For example, some commenters sought to exclude from the calculation proprietary assets and assets managed without compensation because such a requirement would be inconsistent with the statutory definition of "investment adviser."[342] Although a person is not an "investment adviser" for purposes of the Advisers Act unless it receives compensation for providing advice to others, once a person meets that definition (by receiving compensation from *any* client to which it provides advice), the person is an adviser, and the Advisers Act applies to the relationship between the adviser and any of its clients (whether or not the adviser receives compensation from them).[343] Both the private fund adviser exemption and the foreign private adviser

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341 *See also* Implementing Adopting Release, *supra* note 32, discussion at section II.A.3.

342 *See, e.g.*, Dechert General Letter; Seward Letter. *See also* ABA Letter; AIMA Letter (suggested a 12-month exclusion for seed capital consistent with the Volcker rule); Dechert Foreign Adviser Letter; EFAMA Letter; Katten Foreign Advisers Letter; MFA Letter. Under section 202(a)(11) of the Advisers Act, the definition of "investment adviser" includes, among others, "any person who, for compensation, engages in the business of advising others . . . as to the value of securities or as to the advisability of investing in, purchasing, or selling securities . . . ." One commenter argued that including proprietary assets would deter non-U.S. advisers that manage large amounts of proprietary assets from establishing U.S. operations. Katten Foreign Advisers Letter. Such an adviser, however, would not be ineligible for the private fund adviser exemption merely because it established U.S. operations. As discussed below, a non-U.S. adviser may rely on the private fund adviser exemption while also having one or more U.S. places of business, provided it complies with the exemption's conditions. *See infra* Section II.B.3.

343 *See* Implementing Adopting Release, *supra* note 32, at n.74 and accompanying text. Several commenters also asserted that including proprietary assets as proposed would in effect require a wholly owned control affiliate to register as an investment adviser. *See, e.g.,* Comment Letter of American Insurance Association (Jan. 24, 2011) ("AIA Letter"); Comment Letter of Katten Muchin Rosenman LLP (on behalf of APG Asset Management US Inc.) (Jan. 21, 2011); Comment Letter of Katten Muchin Rosenman LLP (Jan. 24, 2011) (on behalf of Certain Non-U.S. Insurance Companies) ("Katten Foreign Insurance Letter"). Whether a control affiliate is deemed to be an "investment adviser" under the Advisers Act because, among other things, it

exemption are conditioned upon an adviser not exceeding specified amounts of "assets under management."[344] Neither statutory exemption limits the types of assets that should be included in this term, and we do not believe that such limits would be appropriate.[345] In our view, the source of the assets managed should not affect the availability of the exemptions.

We also do not expect that advisers' principals (or other employees) generally will cease to invest alongside the advisers' clients as a result of the inclusion of proprietary assets, as some commenters suggested.[346] If private fund investors value their advisers' co-investments as suggested by these commenters, we expect that the investors will demand them and their advisers will structure their businesses accordingly.[347]

Other commenters objected to calculating regulatory assets under management on the basis of gross, rather than net, assets.[348] They argued, among other things, that gross asset measurements would be confusing,[349] complex,[350] and inconsistent with industry practice.[351]

"engages in the business of advising others" will depend on the particular facts and circumstances. The calculation of regulatory assets under management, including the mandatory or optional inclusion of specified assets in that calculation, is applicable after the entity is determined to be an investment adviser.

344 *See* sections 203(m) and 202(a)(30) of the Advisers Act.

345 *See also* Implementing Adopting Release, *supra* note 32, at n.75 and accompanying text (explaining that "the management of 'proprietary' assets or assets for which the adviser may not be compensated, when combined with other client assets, may suggest that the adviser's activities are of national concern or have implications regarding the reporting for the assessment of systemic risk").

346 *See, e.g.*, ABA Letter; Katten Foreign Advisers Letter; Seward Letter.

347 Moreover, we note that an adviser seeking to rely on rule 203(m)-1 may have only private fund clients and must include the assets of all of its private fund clients when determining if it remains under the rule's $150 million threshold.

348 ABA Letter; Dechert General Letter; Merkl Letter; MFA Letter; Seward Letter; Shearman Letter.

349 Dechert General Letter. *See also* Implementing Adopting Release, *supra* note 32, at n.80 and accompanying text.

350 MFA Letter.

However, nothing in the current instructions suggests that liabilities should be deducted from the calculation of an adviser's assets under management. Indeed, since 1997, the instructions have stated that an adviser should not deduct securities purchased on margin when calculating its assets under management.[352] Whether a client has borrowed to purchase a portion of the assets managed does not seem to us a relevant consideration in determining the amount an adviser has to manage, the scope of the adviser's business, or the availability of the exemptions.[353]

Moreover, we are concerned that the use of net assets could permit advisers to highly leveraged funds to avoid registration under the Advisers Act even though the activities of such advisers may be significant and the funds they advise may be appropriate for systemic risk reporting.[354] One commenter argued, in contrast, that it would be "extremely unlikely that a net

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351 *See, e.g.*, Merkl Letter; Shearman Letter. One commenter asserted that the "inclusion of borrowed assets may create an incentive for an adviser to reduce client borrowings to qualify for an exemption from registration even though reducing leverage may not be in the best interest of its clients," and that it "could encourage advisers to use methods other than borrowing to obtain financial leverage for their clients (*e.g.*, through swaps or other derivative products, which could be disadvantageous to clients due to the counterparty risks and increased costs that they entail)." Seward Letter. *See also* Gunderson Dettmer Letter. We note that advisers, as fiduciaries, may not subordinate clients' interests to their own such as by altering their investing behavior in a way that is not in the client's best interest in an attempt to remain under the exemption's $150 million threshold. Another commenter argued that a gross assets calculation would make calculations of regulatory assets under management more volatile. *See* Dechert General Letter. As discussed in more detail below, we are permitting advisers relying on rule 203(m)-1 to calculate their private fund assets annually, rather than quarterly as proposed, and are extending the period during which certain advisers may file their registration applications if their private fund assets exceed the exemption's $150 million threshold. *See infra* Section II.B.2.b. We believe these measures will substantially mitigate or eliminate any volatility that may be caused by using a gross assets measurement, as well as potential volatility in currency exchange rates identified by some commenters. *See* CompliGlobe Letter; EVCA Letter; O'Melveny Letter.

352 *See* Form ADV: Instructions for Part 1A, instr. 5.b.(2), as in effect before it was amended by the Implementing Adopting Release ("Do not deduct securities purchased on margin."). Instruction 5.b.(2), as amended in the Implementing Adopting Release, provides "Do not deduct any outstanding indebtedness or other accrued but unpaid liabilities." *See* Implementing Adopting Release, *supra* note 32, discussion at section II.A.3.

353 *See id*.

354 *See id.*, at n.82 and preceding and accompanying text.

asset limit of $150,000,000 in private funds could be leveraged into total investments that would pose any systemic risk."[355] But a comprehensive view of systemic risk requires information about certain funds that may not present systemic risk concerns when viewed in isolation, but nonetheless are relevant to an assessment of systemic risk across the economy. Moreover, because private funds are not subject to the leverage restrictions in section 18 of the Investment Company Act, a private fund with less than $150 million in net assets could hold assets far in excess of that amount as a result of its extensive use of leverage. In addition, under a net assets test such a fund would be treated similarly for regulatory purposes as a fundamentally different fund, such as one that did not make extensive use of leverage and had $140 million in net assets.

The use of gross assets also need not cause any investor confusion, as some commenters suggested.[356] Although an adviser will be required to use gross (rather than net) assets for purposes of determining whether it is eligible for the private fund adviser or the foreign private adviser exemptions (among other purposes), we would not preclude an adviser from holding itself out to its clients as managing a net amount of assets as may be its custom.[357]

One commenter opposed the requirement that advisers include in the calculation of private fund assets uncalled capital commitments, asserting that the uncalled capital remains

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355 ABA Letter.

356 *See, e.g.,* Dechert General Letter. *See also* Implementing Adopting Release, *supra* note 32, at n.80 and accompanying text.

357 In addition, in response to commenters seeking clarification of the application of the gross assets calculation to mutual funds, short positions and leverage, we expect that advisers will continue to calculate their gross assets as they do today, even if they currently only calculate gross assets as an intermediate step to compute their net assets. *See* Implementing Adopting Release, *supra* note 32, at n.83. In the case of pooled investment vehicles with a balance sheet, for instance, an adviser could include in the calculation the total assets of the entity as reported on the balance sheet. *Id.*

under the management of the fund investor.[358] As we noted in the Proposing Release, in the early years of a private fund's life, its adviser typically earns fees based on the total amount of capital commitments, which we presume reflects compensation for efforts expended on behalf of the fund in preparation for the investments.[359]

A number of commenters objected to the requirement to determine private fund assets based on fair value, generally arguing that the requirement would cause those advisers that did not use fair value methods to incur additional costs, especially if the private funds' assets that they manage are illiquid and therefore difficult to fair value.[360] We noted in the Proposing Release that we understood that many private funds already value assets in accordance with U.S. generally accepted accounting principles ("GAAP") or other international accounting standards that require the use of fair value, citing letters we had received in connection with other rulemaking initiatives.[361] We are sensitive to the costs this new requirement will impose. We believe, however, that this approach is warranted in light of the unique regulatory purposes of the calculation under the Advisers Act. We estimated these costs in the Proposing Release[362] and we have taken several steps to mitigate them.[363]

While many advisers will calculate fair value in accordance with GAAP or another

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358 *See* Merkl Letter.

359 Proposing Release, *supra* note 26, discussion at section II.B.2. *See also* Implementing Adopting Release, supra note 32, at n.90 and accompanying text.

360 *See, e.g.*, Gunderson Dettmer Letter; Merkl Letter; O'Melveny Letter; Seward Letter; Wellington Letter.

361 *See* Proposing Release, *supra* note 26, at n.196 and accompanying text.

362 *See id.*, at n.326 and accompanying text.

363 We recognize that although these steps will provide advisers greater flexibility in calculating the value of their private fund assets, they also will result in valuations that are not as comparable as they could be if we specified a fair value standard (*e.g.*, as specified in GAAP).

international accounting standard,[364] other advisers acting consistently and in good faith may utilize another fair valuation standard.[365] While these other standards may not provide the quality of information in financial reporting (for example, of private fund returns), we expect these calculations will provide sufficient consistency for the purposes that regulatory assets under management serve in our rules, including rule 203(m)-1.[366]

Commenters also suggested alternative approaches to valuation, including the use of local accounting principles;[367] the methodology used to report to the private fund's investors;[368] the

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364 Several commenters asked that we not require advisers to fair value private fund assets in accordance with GAAP for purposes of calculating regulatory assets under management because many funds, particularly offshore ones, do not use GAAP and such a requirement would be unduly burdensome. *See, e.g.,* EFAMA Letter; Katten Foreign Advisers Letter. We did not propose such a requirement, nor are we adopting one. *See* Implementing Adopting Release, *supra* note 32, at n.98.

365 *See id.*, at n.99 and accompanying text. Consistent with this good faith requirement, we would expect that an adviser that calculates fair value in accordance with GAAP or another basis of accounting for financial reporting purposes will also use that same basis for purposes of determining the fair value of its regulatory assets under management. *Id.*

366 *See id.*, at n.100 and accompanying text. In addition, the fair valuation process need not be the result of a particular mandated procedure and the procedure need not involve the use of a third-party pricing service, appraiser or similar outside expert. An adviser could rely on the procedure for calculating fair value that is specified in a private fund's governing documents. The fund's governing documents may provide, for example, that the fund's general partner determines the fair value of the fund's assets. Advisers are not, however, required to fair value real estate assets only in those limited circumstances where real estate assets are not required to be fair valued for financial reporting purposes under accounting principles that otherwise require fair value for assets of private funds. For example, in those cases, an adviser may instead value the real estate assets as the private fund does for financial reporting purposes. We note that the Financial Accounting Standards Board ("FASB") has a current project related to investment property entities that may require real estate assets subject to that accounting standard to be measured by the adviser at fair value. *See* FASB Project on *Investment Properties*. We also note that certain international accounting standards currently permit, but do not require, fair valuation of certain real estate assets. *See* International Accounting Standard 40, *Investment Property*. To the extent that an adviser follows GAAP or another accounting standard that requires or in the future requires real estate assets to be fair valued, this limited exception to the use of fair value measurement for real estate assets would not be available.

367 Dechert Foreign Adviser Letter; EFAMA Letter.

368 Merkl Letter; Wellington Letter.

methodologies described in a client's governing documents or offering materials;[369] historical cost;[370] and aggregate capital raised by a private fund.[371] Use of these approaches would limit our ability to compare data from different advisers and thus would be inconsistent with our goal of achieving more consistent asset calculations and reporting across the industry, as discussed above, and also could result in advisers managing comparable amounts of assets under management being subject to different registration requirements. Moreover, these alternative approaches could permit advisers to circumvent the Advisers Act's registration requirements. Permitting the use of any valuation standard set forth in the governing documents of the private fund other than fair value could effectively yield to the adviser the choice of the most favorable standard for determining its registration obligation as well as the application of other regulatory requirements.

For these reasons and as we proposed, rule 203(m)-1 requires advisers to calculate the value of private fund assets pursuant to the instructions in Form ADV.

b. Frequency of Calculation and Transition Period

An adviser relying on the exemption provided by rule 203(m)-1 must annually calculate the amount of the private fund assets it manages and report the amount in its annual updating amendments to its Form ADV.[372] If an adviser reports in its annual updating amendment that it

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369 AIMA Letter; MFA Letter; Seward Letter.

370 O'Melveny Letter.

371 Gunderson Dettmer Letter.

372 An adviser relying on rule 203(m)-1 must file an annual updating amendment to its Form ADV within 90 days after the end of its fiscal year, and must calculate its private fund assets in the manner described in the instructions to Form ADV within 90 days prior to the date it makes the filing. *See* rule 203(m)-1(c); rule 204-4(a); General Instruction 4 to Form ADV; Form ADV: Instructions for Part 1A, instr. 5.b. The adviser must report its private fund assets on Section 2.B of Schedule D to Form ADV. Advisers also must report their private fund assets when they file

has $150 million or more of private fund assets under management, the adviser is no longer eligible for the private fund adviser exemption.[373] Advisers thus may be required to register under the Advisers Act as a result of increases in their private fund assets that occur from year to year, but changes in the amount of an adviser's private fund assets between annual updating amendments will not affect the availability of the exemption.

We proposed to require advisers relying on the exemption to calculate their private fund assets each quarter to determine if they remain eligible for the exemption. Commenters persuaded us, however, that requiring advisers to calculate their private fund assets annually in connection with their annual updating amendments to Form ADV would be more appropriate because it would likely result in the same advisers becoming registered each year while reducing the costs and burdens associated with quarterly calculations.[374] In addition, annual calculations provide a range of dates on which an adviser may calculate its private fund assets, addressing concerns raised by commenters about shorter-term fluctuations in assets under management.[375] The rule as adopted also is consistent with the timeframes for valuing assets under management

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their initial reports as exempt reporting advisers. *See* Implementing Adopting Release, *supra* note 32, discussion at section II.B.

373 Under Item 2.B of Part 1A of Form ADV, an adviser relying on rule 203(m)-1 must complete Section 2.B of Schedule D, which requires the adviser to provide the amount of the "private fund assets" it manages. A note to Section 2.B of Schedule D provides that "private fund assets" has the same meaning as under rule 203(m)-1, and that non-U.S. advisers should only include private fund assets that they manage at a place of business in the United States. *See also infra* notes 377-378 and accompanying text.

374 A number of commenters argued, among other things, that calculating private fund assets quarterly would: (i) impose unnecessary costs and burdens on advisers, some of whom might not otherwise perform quarterly valuations; and (ii) inappropriately permit shorter-term fluctuations in assets under management to require advisers to register. *See* ABA Letter; AIMA Letter; Dechert Foreign Adviser Letter; Dechert General Letter; EFAMA Letter; Katten Foreign Advisers Letter; Merkl Letter; NASBIC/SBIA Letter; Seward Letter.

375 As discussed above, an adviser relying on rule 203(m)-1 must calculate its private fund assets in the manner described in the instructions to Form ADV within 90 days prior to the date it files its annual updating amendment to its Form ADV.

and registering with the Commission applicable to state-registered advisers switching from state to Commission registration.[376]

As noted above, if an adviser reports in its annual updating amendment that it has $150 million or more of private fund assets under management, the adviser is no longer eligible for the exemption and must register under the Advisers Act unless it qualifies for another exemption. An adviser that has complied with all Commission reporting requirements applicable to an exempt reporting adviser as such, however, may apply for registration with the Commission up to 90 days after filing the annual updating amendment, and may continue to act as a private fund adviser, consistent with the requirements of rule 203(m)-1, during this transition period.[377] This 90-day transition period is not available to advisers that have failed to comply with all Commission reporting requirements applicable to an exempt reporting adviser as such or that have accepted a client that is not a private fund.[378] These advisers therefore should plan to

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376 *See* General Instruction 4 to Form ADV; Form ADV: Instructions for Part 1A, instr. 5.b.; rule 203A-1(b). *See also* ABA Letter ("We believe an annual measurement would be most appropriate, especially since advisers exempt from registration because they do not meet the $100,000,000 asset threshold will calculate their assets for this purpose annually, and an annual test for both purposes has a compelling consistency.").

377 General Instruction 15 to Form ADV. *See also* Implementing Adopting Release, *supra* note 32, discussion at section II.B.5. We removed what was proposed rule 203(m)-1(d), which contained the proposed transition period, and renumbered the final rule accordingly. The transition period as adopted is described in General Instruction 15 to Form ADV. Rule 203(m)-1(c) refers advisers to this instruction. This transition period is available to an adviser that has complied with "all [Commission] reporting requirements applicable to an exempt reporting adviser as such," rather than "all applicable Commission reporting requirements," as proposed. This condition reflects the importance of the Advisers Act reporting requirements applicable to advisers relying on the private fund adviser exemption.

378 General Instruction 15 to Form ADV. *See also* Implementing Adopting Release, *supra* note 32, discussion at section II.B.5. An adviser would lose the exemption immediately upon accepting a client that is not a private fund. Accordingly, for the adviser to comply with the Advisers Act, the adviser's Commission registration must be approved before the adviser accepts a client that is not a private fund. Moreover, even an adviser to whom the transition period is available could not, consistent with the Advisers Act, accept a client that is not a private fund until the Commission

register before becoming ineligible for the exemption.

Commenters who addressed the issue generally supported the proposed transition period, but requested that we extend the transition period beyond one calendar quarter as proposed or otherwise make it more broadly available.[379] Requiring annual calculations extends the transition period, as commenters recommended, and is consistent with the amount of time provided to state-registered advisers switching to Commission registration. Advisers to whom the transition period is available will have up to 180 days after the end of their fiscal years to register.[380]

One commenter argued that the transition period should be available to all advisers relying on rule 203(m)-1, including those that had not complied with their reporting requirements.[381] The transition period is a safe harbor that provides advisers flexibility in complying with rule 203(m)-1, and we continue to believe that it would be inappropriate to extend this benefit to advisers that have not met their reporting requirements.[382]

3. Assets Managed in the United States

Under rule 203(m)-1, all of the private fund assets of an adviser with a principal office and place of business in the United States are considered to be "assets under management in the

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approves its registration. These same limitations apply to non-U.S. advisers with respect to their clients that are United States persons.

[379] ABA Letter; AIMA Letter; CompliGlobe Letter; Gunderson Dettmer Letter; Katten Foreign Advisers Letter; Sadis & Goldberg Implementing Release Letter; Seward Letter; Shearman Letter.

[380] An adviser must file its annual Form ADV updating amendment within 90 days after the end of its fiscal year and, if the transition period is available, may apply for registration up to 90 days after filing the amendment. *See also supra* note 378.

[381] Shearman Letter.

[382] *See* Proposing Release, *supra* note 26, discussion at n.223 and accompanying text.

United States," even if the adviser has offices outside of the United States.[383] A non-U.S. adviser, however, need only count private fund assets it manages at a place of business in the United States toward the $150 million asset limit under the exemption.[384]

As discussed in the Proposing Release, the rule deems all of the assets managed by an adviser to be managed "in the United States" if the adviser's "principal office and place of business" is in the United States. This is the location where the adviser controls, or has ultimate responsibility for, the management of private fund assets, and therefore is *the* place where all the adviser's assets are managed, although day-to-day management of certain assets may also take place at another location.[385] For most advisers, this approach will avoid difficult attribution determinations that would be required if assets are managed by teams located in multiple jurisdictions, or if portfolio managers located in one jurisdiction rely heavily on research or other advisory services performed by employees located in another jurisdiction.

Most commenters who addressed the issue supported our proposal to treat "assets under management in the United States" for non-U.S. advisers as those assets managed at a U.S. place

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383 Rule 203(m)-1(a). The rule defines the "United States" to have the same meaning as in rule 902(l) of Regulation S under the Securities Act, which is "the United States of America, its territories and possessions, any State of the United States, and the District of Columbia." Rule 203(m)-1(d)(7); 17 CFR 230.902(l).

384 Rule 203(m)-1(b). Any assets managed at a U.S. place of business for clients other than private funds would make the exemption unavailable. *See also supra* note 378. We revised this provision to refer to assets managed "at" a place of business in the United States, rather than "from" a place of business in the United States as proposed. The revised language is intended to reflect more clearly the rule's territorial focus on the location at which the asset management takes place.

385 This approach is similar to the way we have identified the location of the adviser for regulatory purposes under our current rules, which define an adviser's principal office and place of business as the location where it "directs, controls and coordinates" its advisory activities, regardless of the location where some of the advisory activities might occur. *See* rule 203A-3(c); rule 222-1.

of business.[386] One commenter did, however, urge us to presume that a non-U.S. adviser's assets are managed from its principal office and place of business to avoid the inherent difficulties in determining the location from which any particular assets of a private fund are managed if an adviser operates in multiple jurisdictions.[387] As we stated in the Proposing Release, this commenter's approach ignores situations in which day-to-day management of some assets of the private fund does in fact take place "in the United States."[388] It also would permit an adviser engaging in substantial advisory activities in the United States to escape our regulatory oversight merely because the adviser's principal office and place of business is outside of the United States. This consequence is at odds not only with section 203(m), but also with the foreign private adviser exemption discussed below in which Congress specifically set forth circumstances under which a non-U.S. adviser may be exempt provided it does not have any place of business in the United States, among other conditions.[389]

In addition, some commenters supported an alternative approach under which we would interpret "assets under management in the United States" by reference to the source of the assets (*i.e.*, U.S. private fund investors).[390] One of the commenters argued that our interpretation would

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386 ABA Letter; Comment Letter of Association Française de la Gestion financière (Jan. 24, 2011) ("AFG Letter") (sought clarification that assets managed from non-U.S. offices are exempted); AIMA Letter; Comment Letter of Avoca Capital Holdings (Dec. 21, 2010) ("Avoca Letter"); Debevoise Letter; Dechert Foreign Adviser Letter; EFAMA Letter; Gunderson Dettmer Letter; Katten Foreign Advisers Letter; MAp Airports Letter; Merkl Letter; Comment Letter of Non-U.S. Adviser (Jan. 24, 2011) ("Non-U.S. Adviser Letter"). *Cf.* Sen. Levin Letter (advisers managing assets in the United States of funds incorporated outside of the United States "are exactly the type of investment advisers to which the Dodd-Frank Act's registration requirements are intended to apply").

387 Katten Foreign Advisers Letter.

388 *See* Proposing Release, *supra* note 26, at nn.204-205 and accompanying text.

389 *See infra* Section II.C.

390 Comment Letter of Portfolio Manager (Jan. 24, 2011) ("Portfolio Manager Letter"); Merkl Letter (suggested that it "may be useful" to look both to assets managed from a U.S. place of business

disadvantage U.S.-based advisers by permitting non-U.S. advisers to accept substantial amounts of money from U.S. investors without having to comply with certain U.S. regulatory requirements, and cause U.S. advisers to move offshore or close U.S. offices to avoid regulation.[391]

As we explained in the Proposing Release, we believe that our interpretation recognizes that non-U.S. activities of non-U.S. advisers are less likely to implicate U.S. regulatory interests and is in keeping with general principles of international comity.[392] The rule also is designed to encourage the participation of non-U.S. advisers in the U.S. market by applying the U.S. securities laws in a manner that does not impose U.S. regulatory and operational requirements on a non-U.S. adviser's non-U.S. advisory business.[393] Non-U.S. advisers relying on rule 203(m)-1 will remain subject to the Advisers Act's antifraud provisions and will become subject to the requirements applicable to exempt reporting advisers.

One commenter proposed an additional interpretation under which we would determine the "assets under management in the United States" for U.S. advisers only by reference to the

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and assets contributed by U.S. private fund investors to address both investor protection and systemic risk concerns).

391 Portfolio Manager Letter. *See also* Comment Letter of Tuttle (Nov. 30, 2010) (submitted in connection with the Implementing Adopting Release, avail. at http://www.sec.gov/comments/s7-35-10/s73510.shtml) ("Tuttle Implementing Release Letter") (argued that businesses may move offshore if they become too highly regulated in the United States).

392 *See* Proposing Release, *supra* note 26, at n.207 (identifying Regulation S and Exchange Act rule 15a-6 as examples of Commission rules that adopt a territorial approach).

393 *See generally* Division of Investment Management, SEC, *Protecting Investors: A Half Century of Investment Company Regulation*, May 1992 ("1992 Staff Report"), at 223-227 (recognizing that non-U.S. advisers that registered with the Commission were arguably subject to all of the substantive provisions of the Advisers Act with respect to their U.S. and non-U.S. clients, which could result in inconsistent regulatory requirements or practices imposed by the regulations of their local jurisdiction and the U.S. securities laws; in response, advisers could form separate and independent subsidiaries but this could result in U.S. clients having access to a limited number of advisory personnel and reduced access by the U.S. subsidiary to information or research by non-U.S. affiliates).

amount of assets invested, or "in play," in the United States.[394] We decline to adopt this approach because it would be difficult for advisers to ascertain and monitor which assets are invested in the United States, and this approach thus could be confusing and difficult to apply on a consistent basis. For example, an adviser might invest in the American Depositary Receipts of a company incorporated in Bermuda that: (i) engages in mining operations in Canada, the principal trading market for its common stock; and (ii) derives the majority of its revenues from exports to the United States. It is not clear whether these investments should be considered "in play" in the United States.

Another commenter urged us to exclude assets managed by a U.S. adviser at its non-U.S. offices.[395] This, the commenter argued, would allow more U.S. advisers to rely on the exemption and allow us to focus our resources on larger advisers more likely to pose systemic risk. But the management of assets at these non-U.S. offices could have investor protection implications in the United States, such as by creating conflicts of interest for an adviser between assets managed abroad and those managed in the United States.

In addition, we sought comment as to whether, under the approach we are adopting today, some or most U.S. advisers with non-U.S. branch offices would re-organize those offices as subsidiaries in order to avoid attributing assets managed to the non-U.S. office.[396] No commenter suggested this would occur. We continue to believe that rule 203(m)-1 will have only a limited effect on multi-national advisory firms, which for tax or business reasons keep their non-U.S. advisory activities organizationally separate from their U.S. advisory activities.

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394 Comment Letter of Richard Dougherty (Dec. 14, 2010) ("Dougherty Letter").

395 Comment Letter of T.A. McKay & Co., Inc. (Nov. 23, 2010).

396 *See* Proposing Release, *supra* note 26, at discussion following n.208.

For these reasons, and our substantial interest in regulating all of the activities of U.S. advisers, we decline to revise rule 203(m)-1 as this commenter suggested.

Several commenters asked that we clarify whether certain U.S. activities or arrangements would result in an adviser having a "place of business" in the United States.[397] Commenters also sought guidance as to whether limited-purpose U.S. offices of non-U.S. advisers would be considered U.S. places of business (*e.g.*, offices conducting research or due diligence).[398]

Under rule 203(m)-1, if a non-U.S. adviser relying on the exemption has a place of business in the United States, all of the clients whose assets the adviser manages at that place of business must be private funds and the assets managed at that place of business must have a total value of less than $150 million. Rule 203(m)-1 defines a "place of business" by reference to rule 222-1(a) as any office where the adviser "regularly provides advisory services, solicits, meets with, or otherwise communicates with clients," and "any other location that is held out to the general public as a location at which the investment adviser provides investment advisory services, solicits, meets with, or otherwise communicates with clients."

Whether a non-U.S. adviser has a place of business in the United States depends on the facts and circumstances, as discussed below in connection with the foreign private adviser exemption.[399] For purposes of rule 203(m)-1, however, the analysis frequently will turn not on whether a non-U.S. adviser has a U.S. place of business, but on whether the adviser manages assets, or has "assets under management," at such a U.S. place of business. Under the Advisers Act, "assets under management" are the securities portfolios for which an adviser provides

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397 *See, e.g.*, EFAMA Letter.

398 AIMA Letter; Dechert General Letter; EFAMA Letter. *See also* ABA Letter; Vedanta Letter.

399 *See infra* Section II.C.4.

"continuous and regular supervisory or management services."[400] This is an inherently factual determination. We would not, however, view providing research or conducting due diligence to be "continuous and regular supervisory or management services" at a U.S. place of business if a person outside of the United States makes independent investment decisions and implements those decisions.[401]

4. United States Person

Under rule 203(m)-1(b), a non-U.S. adviser may not rely on the exemption if it has any client that is a United States person other than a private fund.[402] Rule 203(m)-1 defines a "United States person" generally by incorporating the definition of a "U.S. person" in Regulation S under the Securities Act.[403] Regulation S looks generally to the residence of an individual to

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400 Section 203A(a)(2) of the Advisers Act. The instructions to Item 5 of Form ADV provide guidance on the circumstances under which an adviser would be providing "continuous and regular supervisory or management services with respect to an account." Form ADV: Instructions for Part 1A, instr. 5.b. The calculation of an adviser's assets under management at a U.S. place of business turns on whether the adviser is providing those services with respect to a particular account or accounts at a U.S. place of business.

401 *See* Form ADV: Instructions for Part 1A, instr. 5.b(3)(b) (an adviser provides continuous and regular supervisory or management services with respect to an account if it has "ongoing responsibility to select or make recommendations, based upon the needs of the client, as to specific securities or other investments the account may purchase or sell and, if such recommendations are accepted by the client, [it is] responsible for arranging or effecting the purchase or sale"). These research or due diligence services, while not "continuous and regular supervisory or management services," may be investment advisory services that, if performed at a U.S. location, would cause the adviser to have a place of business in the United States. *See infra* note 493 and accompanying text.

402 In response to commenters seeking clarity on this point, we note that a non-U.S. adviser need not have one or more private fund clients that are United States persons in order to rely on the exemption.

403 Rule 203(m)-1(d)(8). We are adding a note to rule 203(m)-1 that clarifies that a client will not be considered a United States person if the client was not a United States person at the time of becoming a client of the adviser. This will permit a non-U.S. adviser to continue to rely on rule 203(m)-1 if a non-U.S. client that is not a private fund, such as a natural person client residing abroad, relocates to the United States or otherwise becomes a United States person. As one commenter recognized, this also will establish similar treatment in these circumstances for non-U.S. advisers relying on rule 203(m)-1 or the foreign private adviser exemption, which contains

determine whether the individual is a United States person,[404] and also addresses the circumstances under which a legal person, such as a trust, partnership or a corporation, is a United States person.[405] Regulation S generally treats legal partnerships and corporations as United States persons if they are organized or incorporated in the United States, and analyzes trusts by reference to the residence of the trustee.[406] It treats discretionary accounts generally as United States persons if the fiduciary is a resident of the United States.[407] Commenters generally supported defining "United States person" by reference to Regulation S because, among other reasons, the definition is well developed and understood by advisers.[408]

Rule 203(m)-1 also contains a special rule that requires an adviser relying on the exemption to treat a discretionary or other fiduciary account as a United States person if the account is held for the benefit of a United States person by a non-U.S. fiduciary who is a related person of the adviser.[409] One commenter expressed concern that the special rule is unnecessary

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an analogous note. *See* EFAMA Letter. *See also* Comment Letter of Investment Funds Institute of Canada (Jan. 24, 2011) ("IFIC Letter"). The note applicable to the foreign private adviser exemption generally describes the time when an adviser must determine if a person is "in the United States" for purposes of that exemption. *See infra* Section II.C.3.

404 17 CFR 230.902(k)(1)(i).

405 *See, e.g.*, 17 CFR 230.902(k)(1) and (2).

406 17 CFR 230.902(k)(1)(ii) and (iv).

407 17 CFR 230.902(k)(1)(vii).

408 AIMA Letter; CompliGlobe Letter; Debevoise Letter; Dechert General Letter; Gunderson Dettmer Letter; Katten Foreign Advisers Letter; O'Melveny Letter. As we explained in the Proposing Release, advisers to private funds and their counsel must today be familiar with the definition of "U.S. person" under Regulation S in order to comply with other provisions of the federal securities laws. *See* Proposing Release, *supra* note 26, at n.217 and accompanying text.

409 Rule 203(m)-1(d)(8) provides that a "United States person means any person that is a 'U.S. person' as defined in [Regulation S], except that any discretionary account or similar account that is held for the benefit of a United States person by a dealer or other professional fiduciary is a United States person if the dealer or professional fiduciary is a related person of the investment adviser relying on [rule 203(m)-1] and is not organized, incorporated, or (if an individual) resident in the United States." In contrast, under Regulation S, a discretionary account

while another who supported the special rule as proposed noted that the special rule should be "narrowly drawn" to avoid frustrating legitimate subadvisory relationships between non-U.S. advisers and their U.S. adviser affiliates.[410] We believe that the special rule is narrowly drawn and necessary to prevent advisers from purporting to rely on the exemption and establishing discretionary accounts for the benefit of U.S. clients with an offshore affiliate that would then delegate the actual management of the account back to the adviser.[411]

Another commenter suggested the rule apply a different approach with respect to business entities than that under Regulation S, which as noted above generally treats legal partnerships and corporations as U.S. persons if they are organized or incorporated in the United States.[412] The commenter suggested that advisers should instead look to a business entity's principal office and place of business in certain instances because an entity organized under U.S. law should not necessarily be treated as a United States person if it was formed by a non-United States person to pursue the entity's investment objectives.[413]

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maintained by a non-U.S. fiduciary (such as an investment adviser) is not a "U.S. person" even if the account is owned by a U.S. person. *See* 17 CFR 230.902(k)(1)(vii); 17 CFR 230.902(k)(2)(i).

410 Katten Foreign Advisers Letter; AIMA Letter (noting that the special rule should be narrowly drawn but also stating that "[w]e understand the rationale for the special rule proposed by the Commission for discretionary accounts maintained outside the US for the benefit of US persons and we believe that that is an appropriate safeguard against avoidance of the registration requirement").

411 *See* Proposing Release, *supra* note 26, discussion at section II.B.4.

412 Debevoise Letter (noted that, for example, "a private fund, or an entity that is organized as part of a private fund, may be organized under Delaware law to meet certain regulatory and tax objectives, but the fund's principal office and place of business in fact may be outside the U.S.").

413 The commenter asserted that this approach "would not be inconsistent with Regulation S itself, which treats a partnership or corporation organized under the laws of a foreign jurisdiction as a U.S. person if it was '[f]ormed by a U.S. person principally for the purpose of investing in securities not registered under the [Securities] Act, unless it is organized or incorporated, and owned, by accredited investors . . . who are not natural persons, estates or trusts.'" *See also* Comment Letter of Fulbright & Jaworski L.L.P. (on behalf of a German asset manager) (Jun. 15, 2011) ("Fulbright Letter").

We decline to adopt this suggestion because we believe it is most appropriate to incorporate the definition of "U.S. person" in Regulation S with as few modifications as possible. As noted above, Regulation S provides a well-developed body of law with which advisers to private funds and their counsel must today be familiar in order to comply with other provisions of the federal securities laws. Incorporating this definition in rule 203(m)-1, therefore, makes rule 203(m)-1 easier to apply and fosters consistency across the federal securities laws. Deviations from the definition used in Regulation S, including an entirely different approach to defining a "United States person," would detract from these benefits. Moreover, a test that looks to a business entity's principal office and place of business, as suggested by the commenter, would be difficult for advisers to apply. It frequently is unclear where an investment fund maintains its "principal office and place of business" because investment funds typically have no physical presence or employees other than those of their advisers.

C. Foreign Private Advisers

Section 403 of the Dodd-Frank Act replaces the current private adviser exemption from registration under the Advisers Act with a new exemption for a "foreign private adviser," as defined in new section 202(a)(30).[414] The new exemption is codified as amended section 203(b)(3).

Under section 202(a)(30), a foreign private adviser is any investment adviser that: (i) has no place of business in the United States; (ii) has, in total, fewer than 15 clients in the United

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[414] Section 402 of the Dodd-Frank Act (providing a definition of "foreign private adviser," to be codified at section 202(a)(30) of the Advisers Act). *See supra* notes 22 and 23 and accompanying text.

States and investors in the United States in private funds advised by the investment adviser;[415] (iii) has aggregate assets under management attributable to clients in the United States and investors in the United States in private funds advised by the investment adviser of less than $25 million;[416] and (iv) does not hold itself out generally to the public in the United States as an investment adviser.[417] Section 202(a)(30) authorizes the Commission to increase the $25 million threshold "in accordance with the purposes of this title."[418]

Today we are adopting, substantially as proposed, new rule 202(a)(30)-1, which defines certain terms in section 202(a)(30) for use by advisers seeking to avail themselves of the foreign private adviser exemption, including: (i) "investor;" (ii) "in the United States;" (iii) "place of business;" and (iv) "assets under management."[419] We are also including in rule 202(a)(30)-1 the safe harbor and many of the client counting rules that appeared in rule 203(b)(3)-1.

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415 One commenter suggested that a non-U.S. adviser with no place of business in the United States would not be subject to the Advisers Act unless the adviser has at least one direct U.S. client. *See* Katten Foreign Advisers Letter. *See also* ABA Letter. We note that section 203(a) of the Advisers Act provides that an adviser may not, unless registered, make use of any means or instrumentality of interstate commerce in connection with its business as an investment adviser. Hence, whether a non-U.S. adviser with no place of business in the United States and no U.S. clients would be subject to registration depends on whether there is sufficient use of U.S. jurisdictional means. *See also supra* note 334.

416 Subparagraph (B) of section 202(a)(30) refers to the number of "clients and investors in the United States in private funds," while subparagraph (C) refers to assets of "clients *in the United States* and investors in the United States in private funds" (emphasis added). As noted in the Proposing Release, we interpret these provisions consistently so that only clients *in the United States* and investors in the United States would be counted for purposes of subparagraph (B). *See* Proposing Release, *supra* note 26, at n.225.

417 In addition, the exemption is not available to an adviser that "acts as (I) an investment adviser to any investment company registered under the [Investment Company Act]; or (II) a company that has elected to be a business development company pursuant to section 54 of [that Act], and has not withdrawn its election." Section 202(a)(30)(D)(ii). As noted in the Proposing Release, we interpret subparagraph (II) to prohibit an adviser *that advises* a business development company from relying on the exemption. *See* Proposing Release, *supra* note 26, at n.226.

418 Section 202(a)(30)(C).

419 Rule 202(a)(30)-1(c).

1. Clients

Rule 202(a)(30)-1 includes a safe harbor for advisers to count clients for purposes of the definition of "foreign private adviser" that is similar to the safe harbor that has been included in rule 203(b)(3)-1.[420] The commenter that generally addressed this aspect of our proposed rule agreed with our approach,[421] which was designed to apply a well-developed body of law to give effect to a statutory provision with a similar purpose.

New rule 202(a)(30)-1 allows an adviser to treat as a single client a natural person and: (i) that person's minor children (whether or not they share the natural person's principal residence); (ii) any relative, spouse, spousal equivalent, or relative of the spouse or of the spousal equivalent of the natural person who has the same principal residence;[422] (iii) all accounts of which the natural person and/or the person's minor child or relative, spouse, spousal equivalent, or relative of the spouse or of the spousal equivalent who has the same principal residence are the only primary beneficiaries; and (iv) all trusts of which the natural person and/or the person's minor child or relative, spouse, spousal equivalent, or relative of the spouse or of the spousal

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420 Rule 203(b)(3)-1, which we are rescinding with the Implementing Adopting Release, provided a safe harbor for determining who may be deemed a single client for purposes of the private adviser exemption. We are not, however, carrying over from rule 203(b)(3)-1 a provision that distinguishes between advisers whose principal places of business are inside or outside of the United States. *See* rule 203(b)(3)-1(b)(5). Under the definition of "foreign private adviser," an adviser relying on the exemption may not have any place of business in the United States. *See* section 402 of the Dodd-Frank Act (defining "foreign private adviser"). We are also not including rule 203(b)(3)-1(b)(7), which specifies that a client who is an owner of a private fund is a resident where the client resides at the time of the client's investment in the fund. The provision was vacated by a federal court in *Goldstein, supra* note 14. As discussed below, we are including a provision in rule 202(a)(30)-1 that addresses when an adviser must determine if a client or investor is "in the United States" for purposes of the exemption. *See infra* note 476 and accompanying text.

421 *See* Katten Foreign Advisers Letter.

422 As suggested by a commenter, we incorporated in rule 202(a)(30)-1(a)(1) the concept of a "spousal equivalent," which we define by reference to rule 202(a)(11)(G)-1(d)(9) as "a cohabitant occupying a relationship generally equivalent to that of a spouse." *See* ABA Letter.

equivalent who has the same principal residence are the only primary beneficiaries.[423] Rule 202(a)(30)-1 also permits an adviser to treat as a single "client" (i) a corporation, general partnership, limited partnership, limited liability company, trust, or other legal organization to which the adviser provides investment advice based on the legal organization's investment objectives, and (ii) two or more legal organizations that have identical shareholders, partners, limited partners, members, or beneficiaries.[424]

As proposed, we are omitting the "special rule" providing advisers with the option of not counting as a client any person for whom the adviser provides investment advisory services without compensation.[425] Some commenters argued that an adviser should not have to count such persons, who may be employees and principals of the firm and their family members.[426] But as we explained in the Proposing Release, allowing an adviser not to count as clients persons in the United States who do not compensate the adviser would allow certain advisers to

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[423] Rule 202(a)(30)-1(a)(1). If a client relationship involving multiple persons does not fall within the rule, whether the relationship may appropriately be treated as a single "client" depends on the facts and circumstances.

[424] Rule 202(a)(30)-1(a)(2). In addition, rule 202(a)(30)-1(b)(1) through (3) contain the following related "special rules:" (1) an adviser must count a shareholder, partner, limited partner, member, or beneficiary (each, an "owner") of a corporation, general partnership, limited partnership, limited liability company, trust, or other legal organization, as a client if the adviser provides investment advisory services to the owner separate and apart from the investment advisory services provided to the legal organization; (2) an adviser is not required to count an owner as a client solely because the adviser, on behalf of the legal organization, offers, promotes, or sells interests in the legal organization to the owner, or reports periodically to the owners as a group solely with respect to the performance of or plans for the legal organization's assets or similar matters; and (3) any general partner, managing member or other person acting as an investment adviser to a limited partnership or limited liability company must count the partnership or limited liability company as a client.

[425] *See* rule 203(b)(3)-1(b)(4).

[426] *See* Dechert General Letter ("In many instances, advisers manage the assets of employees and principals of the firm and their family members, and use such services as a legitimate compensation arrangement to retain talented employees."); Katten Foreign Advisers Letter ("Such persons are likely to be in a special relationship with the adviser that allows them to benefit from the advisers' investment advice without having to pay."). *See also* ABA Letter.

avoid registration through reliance on the foreign private adviser exemption despite the fact that, as those commenters acknowledge, the adviser provides advisory services to those persons.[427]

The new rule includes two provisions that clarify that advisers need not double-count private funds and their investors under certain circumstances.[428] One provision, as proposed, specifies that an adviser need not count a private fund as a client if the adviser counted any investor, as defined in the rule, in that private fund as an investor in that private fund for purposes of determining the availability of the exemption.[429] The other provision, recommended by commenters,[430] clarifies that an adviser is not required to count a person as an investor if the adviser counts such person as a client of the adviser.[431] Thus, a client who is also an investor in a private fund advised by the adviser would only be counted once.

2. Private Fund Investor

Section 202(a)(30) provides that a "foreign private adviser" eligible for the new

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427 *Cf.* Form ADV: Glossary (stating that for purposes of Form ADV, the term "client" "includes clients from which [an adviser] receives no compensation . . . ."). We also are adopting in the Implementing Adopting Release a uniform method for calculating assets under management for regulatory purposes, including availability of the foreign private adviser exemption, that requires advisers to include in that calculation assets they manage without compensation. *See* Implementing Adopting Release, *supra* note 32, discussion at section II.A.3. Requiring foreign private advisers to treat as clients persons from whom they receive no compensation is consistent with the use of this new uniform method of calculating assets under management for regulatory purposes.

428 *See* rule 202(a)(30)-1(b)(4)-(5).

429 *See* rule 202(a)(30)-1(b)(4); 202(a)(30)-1(c)(2). *See also infra* Section II.C.2 (discussing the definition of investor). This provision is applicable only for purposes of determining whether an adviser has fewer than 15 clients in the United States and investors in the United States in private funds it advises under section 202(a)(30)(B) of the foreign private adviser exemption. It does not apply to the determination of the assets under management relevant for purposes of that exemption under section 202(a)(30)(C). As a result, an adviser must include the assets of a private fund that is a client in the United States even if the adviser may exclude the private fund when determining whether the adviser has fewer than 15 clients or investors in the United States. *See also infra* note 499.

430 *See* ABA Letter; Katten Foreign Advisers Letter.

431 *See* rule 202(a)(30)-1(b)(5).

registration exemption cannot have more than 14 clients "or investors in the United States in private funds" advised by the adviser. Rule 202(a)(30)-1 defines an "investor" in a private fund as any person who would be included in determining the number of beneficial owners of the outstanding securities of a private fund under section 3(c)(1) of the Investment Company Act, or whether the outstanding securities of a private fund are owned exclusively by qualified purchasers under section 3(c)(7) of that Act.[432] In addition, a beneficial owner of short-term paper issued by the private fund also is an "investor," notwithstanding that holders of short-term paper need not be counted for purposes of section 3(c)(1).[433] Finally, in order to avoid double-counting, the rule clarifies that an adviser may treat as a single investor any person who is an investor in two or more private funds advised by the investment adviser.[434] We are adopting rule 202(a)(30)-1 substantially as proposed. In a modification to the proposal, however, we are not including knowledgeable employees in the definition of "investor."[435]

The term "investor" is not currently defined under the Advisers Act or the rules under the Advisers Act. We are adopting the new definition to provide for consistent application of the statutory provision and to prevent non-U.S. advisers from circumventing the limitations in section 203(b)(3). As discussed in the Proposing Release, we believe that defining the term "investor" by reference to sections 3(c)(1) and 3(c)(7) of the Investment Company Act will best achieve these purposes.

Commenters who addressed the issue agreed with our decision to define investor for

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432 *See* rule 202(a)(30)-1(c)(2)(i); *supra* notes 10 and 12 and accompanying text. We note that the definition of "investor" in rule 202(a)(30)-1 is for purposes of the foreign private adviser exemption and does not limit the scope of that term for purposes of rule 206(4)-8.

433 *See* rule 202(a)(30)-1(c)(2)(ii).

434 *See* rule 202(a)(30)-1(c)(2), at note to paragraph (c)(2).

435 *See* rule 202(a)(30)-1(c)(2). *See also infra* notes 448-452 and accompanying text.

purposes of this rule by reference to the well-developed understanding of ownership under sections 3(c)(1) and 3(c)(7).[436] Funds and their advisers must determine who is a beneficial owner for purposes of section 3(c)(1) or whether an owner is a qualified purchaser for purposes of section 3(c)(7).[437] More importantly, defining the term "investor" by reference to sections 3(c)(1) and 3(c)(7) places appropriate limits on the ability of a non-U.S. adviser to avoid application of the registration provisions of the Advisers Act by setting up intermediate accounts through which investors may access a private fund and not be counted for purposes of the exemption. Advisers must "look through" nominee and similar arrangements to the underlying holders of private fund-issued securities to determine whether they have fewer than 15 clients and private fund investors in the United States.[438] Holders of both equity and debt securities must be counted as investors.[439]

Under the new rule, an adviser will determine the number of investors in a private fund based on the facts and circumstances and in light of the applicable prohibition not to do indirectly, or through or by any other person, what is unlawful to do directly.[440] Depending upon the facts and circumstances, persons other than the nominal holder of a security issued by a

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436 *See* ABA Letter; Dechert General Letter; Katten Foreign Advisers Letter.

437 *See supra* notes 10 and 12 and accompanying text. In the Proposing Release, we noted that typically a prospective investor in a private fund must complete a subscription agreement that includes representations or confirmations that it is qualified to invest in the fund and whether it is a U.S. person. This information is designed to allow the adviser (on behalf of the fund) to make the above determination. Therefore, an adviser seeking to rely on the foreign private adviser exemption will have ready access to this information.

438 Rule 202(a)(30)-1(c)(2). *See generally* sections 3(c)(1) and 3(c)(7) of the Investment Company Act.

439 Sections 3(c)(1) and 3(c)(7) of the Investment Company Act refer to beneficial owners and owners, respectively, of "securities" (which is broadly defined in section 2(a)(36) of that Act to include debt and equity).

440 *See* section 208(d) of the Advisers Act; section 48(a) of the Investment Company Act.

private fund may be counted as the beneficial owner under section 3(c)(1), or be required to be a qualified purchaser under section 3(c)(7).[441] An adviser relying on the exemption would have to count such a person as an investor.

For example, the adviser to a master fund in a master-feeder arrangement would have to treat as investors the holders of the securities of any feeder fund formed or operated for the purpose of investing in the master fund rather than the feeder funds, which act as conduits.[442] In addition, an adviser would need to count as an investor an owner of a total return swap on the private fund because that arrangement effectively provides the risks and rewards of investing in the private fund to the swap owner.[443] Whether an owner of another type of instrument

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[441] As noted above, we have recognized that in certain circumstances it is appropriate to "look through" an investor (*i.e.*, attribute ownership of a private fund to another person who is the ultimate owner). *See, e.g.*, *Privately Offered Investment Companies,* Investment Company Act Release No. 22597 (Apr. 3, 1997) [62 FR 17512 (Apr. 9, 1997)] ("NSMIA Release") ("The Commission understands that there are other forms of holding investments that may raise interpretative issues concerning whether a Prospective Qualified Purchaser 'owns' an investment. For instance, when an entity that holds investments is the 'alter ego' of a Prospective Qualified Purchaser (as in the case of an entity that is wholly owned by a Prospective Qualified Purchaser who makes all the decisions with respect to such investments), it would be appropriate to attribute the investments held by such entity to the Prospective Qualified Purchaser.").

[442] A "master-feeder fund" is an arrangement in which one or more funds with the same or consistent investment objectives ("feeder funds") invest all or substantially all of their assets in a single fund ("master fund") with the same or consistent investment objective and strategies. We have taken the same approach within our rules that require a private fund to "look through" any investor that is formed or operated for the specific purpose of investing in a private fund. *See* rule 2a51-3(a) under the Investment Company Act (17 CFR 270.2a51-3(a)) (a company is not a qualified purchaser if it is "formed for the specific purpose of acquiring the securities" of an investment company that is relying on section 3(c)(7) of the Investment Company Act, unless each of the company's beneficial owners is also a qualified purchaser). *See also* NSMIA Release, *supra* note 441 (explaining that rule 2a51-3(a) would limit the possibility that "a company will be able to do indirectly what it is prohibited from doing directly [by organizing] . . . a 'qualified purchaser' entity for the purpose of making an investment in a particular Section 3(c)(7) Fund available to investors that themselves did not meet the definition of 'qualified purchaser'").

[443] One commenter argued that the swap counterparty is not required to hedge its exposure by investing the full notional amount in the private fund. *See* Dechert General Letter. We do not find this distinction persuasive in situations in which the adviser knows or should know of the existence of the swap. *See infra* discussion accompanying and following note 447.

referencing a private fund would be counted as the beneficial owner under section 3(c)(1), or be required to be a qualified purchaser under section 3(c)(7), would depend on the facts and circumstances.

Several commenters generally disagreed that advisers should be required to "look through" total return swaps or similar instruments or master-feeder arrangements in at least certain circumstances, arguing among other things that these instruments or arrangements serve legitimate business purposes.[444] As we explain above, however, the requirement to count as investors persons other than the nominal holder of a security issued by a private fund is derived from provisions in both the Advisers Act and the Investment Company Act prohibiting a person from doing indirectly, or through or by any other person, what is unlawful to do directly, and from sections 3(c)(1) and 3(c)(7).[445]

Some commenters also argued that "looking through" a total return swap or similar instrument would be impractical or unduly burdensome in certain circumstances, including situations in which the adviser did not participate in the swap's creation or know of its existence.[446] An issuer relying on section 3(c)(7) may treat as a qualified purchaser any person whom the issuer reasonably believes is a qualified purchaser, and the definition of investor that we are adopting today provides that an adviser counts as investors those persons who must be qualified purchasers under section 3(c)(7). Therefore, an adviser may treat as an investor a person the adviser reasonably believes is the actual investor.[447] Similarly, if an adviser

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444 *See, e.g.*, ABA Letter; Dechert General Letter; EFAMA Letter.

445 *See supra* notes 440-443 and accompanying text.

446 *See, e.g.*, Dechert General Letter; EFAMA Letter.

447 Rule 202(a)(30)-1(c)(2) defines the term "investor" generally to include persons that must be counted for purposes of section 3(c)(1) of the Investment Company Act or qualified purchasers for purposes of section 3(c)(7) of that Act. *See supra* notes 432-443 and accompanying text.

reasonably believes that an investor is not "in the United States," the adviser may treat the investor as not being "in the United States."

The final rule, unlike the proposal, does not treat as investors beneficial owners who are "knowledgeable employees" with respect to the private fund, and certain other persons related to such employees (we refer to them, collectively, as "knowledgeable employees").[448] In formulating our proposal to include knowledgeable employees in the definition of investor, we were concerned that excluding knowledgeable employees from the definition of investor would allow certain advisers to avoid registration by relying on the foreign private adviser exemption.[449] A number of commenters opposed our proposal.[450] In particular, they argued that the proposed approach was inconsistent with Congressional and prior Commission determinations that such employees do not need the protections of the Investment Company Act.[451]

Advisers to private funds relying on section 3(c)(7) may under Investment Company Act rule 2a51-1(h) treat as qualified purchasers those persons they reasonably believe are qualified purchasers. Persons who must be qualified purchasers for purposes of section 3(c)(7) generally would be the same as those who must be counted for purposes of section 3(c)(1). Accordingly, advisers may, for purposes of determining their investors in the United States under rule 202(a)(30)-1, treat as an investor a person the adviser reasonably believes is the actual investor.

448 *See* proposed rule 202(a)(30)-1(c)(1)(i) (referencing rule 3c-5 under the Investment Company Act (17 CFR 270.3c-5(b)), which excludes from the determinations under sections 3(c)(1) and 3(c)(7) of that Act any securities beneficially owned by knowledgeable employees of a private fund; a company owned exclusively by knowledgeable employees; and any person who acquires securities originally acquired by a knowledgeable employee through certain transfers of interests, such as a gift or a bequest).

449 *See* Proposing Release, *supra* note 26, at n.250 and accompanying text.

450 *See* Dechert General Letter; Katten Foreign Advisers Letter; Seward Letter; Shearman Letter.

451 *See*, *e.g.*, Dechert General Letter ("[The] Commission promulgated the knowledgeable employee safe-harbors for sections 3(c)(1) and 3(c)(7) in response to the Congressional mandate in the National Securities Markets Improvement Act of 1996 to allow certain informed insiders to invest in a private fund without causing the fund to lose its exception under the 1940 Act."); Shearman Letter (the proposed approach is "contrary to a long history of recognizing that knowledgeable employees should be treated differently than other investors and that their privileged status with

Upon further consideration, we have determined that the same policy considerations that justify disregarding knowledgeable employees for purposes of other provisions provide a valid basis for excluding them from the definition of "investor" under the foreign private adviser exemption.[452] Treating knowledgeable employees in the same manner for purposes of the definition of investor and sections 3(c)(1) and 3(c)(7) will also simplify compliance with regulatory requirements imposed by both the Advisers Act and the Investment Company Act.

The new rule requires advisers to treat as investors beneficial owners of "short-term paper"[453] issued by the private fund.[454] These persons are not counted as beneficial owners for purposes of section 3(c)(1) but must be qualified purchasers under section 3(c)(7).[455] Some commenters opposed this approach, arguing that holders of short-term paper do not make an investment decision but rather are creditors making a credit risk evaluation.[456] We disagree. The

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their organizations in terms of influence and access to information reasonably limits the public's interest in their protection").

452 *See* Advisers Act rule 205-3(d)(1)(iii) (specifying that knowledgeable employees are included among the types of clients to whom the adviser may charge performance fees); Advisers Act rule 202(a)(11)(G)-1 (permitting a family office excluded from the definition of investment adviser under the Advisers Act to provide investment advice to its knowledgeable employees). These provisions reflect a policy determination that knowledgeable employees are likely to be in a position or have a level of knowledge and experience in financial matters sufficient to be able to evaluate the risks and take steps to protect themselves.

453 *See* rule 202(a)(30)-1(c)(2)(ii) (referencing the definition of "short-term paper" contained in section 2(a)(38) of the Investment Company Act, which defines "short-term paper" to mean "any note, draft, bill of exchange, or banker's acceptance payable on demand or having a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof payable on demand or having a maturity likewise limited; and such other classes of securities, of a commercial rather than an investment character, as the Commission may designate by rules and regulations").

454 *See* rule 202(a)(30)-1(c)(2)(ii).

455 *See* sections 3(c)(1) and 3(c)(7) of the Investment Company Act.

456 *See* ABA Letter ("[H]olders of short-term securities do not view themselves as making an investment decision in connection with their extension of credit, but rather assess the risk of holding a private fund's short-term paper based on credit risk."); Shearman Letter ("[A] lender to

acquisition of those instruments involves an investment decision, although the considerations involved in that decision might differ from the considerations involved in a decision to make an equity investment.

One commenter asserted that treating holders of short-term paper as investors could result in a U.S. commercial lender to a fund being treated as an investor, leading non-U.S. advisers to avoid U.S. lenders.[457] Unless the extension of credit by a fund's broker-dealer or custodian bank results in the issuance of a security by the fund to its creditor, the creditor would not be considered an investor for purposes of the foreign private adviser exemption.[458]

As we stated in the Proposing Release, there appears to be no valid reason to treat as investors all debt holders *except* holders of short-term paper.[459] Certain issuers continually roll over short-term paper and effectively use it as a permanent source of capital, further supporting our view that there appears to be no reason to treat holders of short-term paper differently than other longer-term debt holders for purposes of the exemption.[460] Moreover, a private fund's

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a fund, while it makes a 'credit analysis,' does not deploy capital based on the perceived skill of the fund manager and so is not an investor by any traditional measure.").

457 *See* Shearman Letter.

458 *See Reves v. Ernst & Young*, 494 U.S. 56 (1990).

459 *See* Proposing Release, *supra* note 26, at n.251 and accompanying text. One commenter agreed that we should not treat short- and longer-term debt holders differently for purposes of the exemption. *See* ABA Letter (asking that we exclude all holders of conventional debt from the definition of investor).

460 As we noted in the Proposing Release, because commercial paper issuers often refinance the repayment of maturing commercial paper with newly issued commercial paper, they may face roll-over risk, *i.e.*, the risk that investors may not be willing to refinance maturing commercial paper. *See* Proposing Release, *supra* note 26, at n.134. These risks became particularly apparent for issuers of asset-backed commercial paper beginning in August 2007. At that time, structured investment vehicles ("SIVs"), which are off-balance sheet funding vehicles sponsored by financial institutions, issued commercial paper to finance the acquisition of long-term assets, including residential mortgages. As a result of problems in the residential home mortgage market, short-term investors began to avoid asset-backed commercial paper tied to residential mortgages, regardless of whether the securities had substantial exposure to sub-prime mortgages.

losses directly affect the interests of holders of short-term paper in the fund just as they affect the interests of other debt holders in the fund.[461] In contrast to the treatment of knowledgeable employees, holders of short-term paper must be qualified purchasers under section 3(c)(7), the more recent of the two exclusions under the Investment Company Act on which private funds rely.[462] Thus, we are requiring advisers to count as investors all debt holders, *including* holders of short-term paper.

Some commenters expressed concern that the look-through requirement contained in the statutory definition of a "foreign private adviser" could impose significant burdens on advisers to non-U.S. funds, including non-U.S. retail funds publicly offered outside of the United States.[463] Two of these commenters stated, for example, that in their view a non-U.S. fund could be considered a private fund as a result of independent actions of U.S. investors, such as if a non-U.S. shareholder of a non-U.S. fund moves to the United States and purchases additional

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Unable to roll over their commercial paper, SIVs suffered severe liquidity problems and significant losses. *See Money Market Fund Reform*, Investment Company Act Release No. 28807 (June 30, 2009) [74 FR 32688 (July 8, 2009)] ("Money Market Fund Reform Release") at nn.37-39 and preceding and accompanying text; MARCIN KACPERCZYK AND PHILIPP SCHNABL, WHEN SAFE PROVED RISKY: COMMERCIAL PAPER DURING THE FINANCIAL CRISIS OF 2007-2009 (Nov. 2009).

461 As discussed in the Proposing Release, various types of investment vehicles make significant use of short-term paper for financing purposes so holders of this type of security are, in practice, exposed to the investment results of the security's issuer. *See* Proposing Release, *supra* note 26, at n.251. *See also* Money Market Fund Reform Release, *supra* note 460, at nn.37-39 and preceding and accompanying text (discussing how money market funds were exposed to substantial losses during 2007 as a result of exposure to debt securities issued by structured investment vehicles).

462 Congress added section 3(c)(7) to the Investment Company in 1996 as part of the National Securities Markets Improvement Act of 1996. Section 3(c)(1) was included in the Investment Company Act when it was enacted in 1940.

463 *See* AFG Letter; Dechert Foreign Adviser Letter; EFAMA Letter; Shearman Letter.

shares.[464] If these funds were "private funds," their advisers would, if seeking to rely on the foreign private adviser exemption, be required to determine the number of private fund investors in the United States and the assets under management attributable to them.

As we explain above, if an adviser reasonably believes that an investor is not "in the United States," the adviser may treat the investor as not being "in the United States." Moreover, we understand that non-U.S. private funds currently count or qualify their U.S. investors in order to avoid regulation under the Investment Company Act.[465] A non-U.S. adviser would need to count the same U.S. investors (except for holders of short-term paper with respect to a fund relying on section 3(c)(1)) in order to rely on the foreign private adviser exemption. In this respect, therefore, the look-through requirement of the foreign private adviser exemption will generally not impose any new burden on advisers to non-U.S. funds.

3. In the United States

Section 202(a)(30)'s definition of "foreign private adviser" employs the term "in the United States" in several contexts, including: (i) limiting the number of – and assets under management attributable to – an adviser's "clients" "in the United States" and "investors in the

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464 Dechert Foreign Adviser Letter; EFAMA Letter. *See also* Comment Letter of Association Française de la Gestion financière (Jun. 14, 2011) (recommended that "investment funds that already are strictly regulated and supervised by European Union regulators should be excluded from the scope of Title IV of the Dodd Frank Act and should not be considered as 'private funds'" because, among other reasons, the commenter's management company members "very often" do not know the identities of their funds' investors, and "therefore should not [] be held responsible if, unbeknownst to them, US persons decide to invest in their funds").

465 This practice is consistent with positions our staff has taken in which the staff has stated it would not recommend enforcement action in certain circumstances. *See, e.g.*, Goodwin Procter No-Action Letter, *supra* note 294; Touche Remnant No-Action Letter, *supra* note 294. *See also* sections 7(d), 3(c)(1), and 3(c)(7) of the Investment Company Act. *See also, e.g.*, Canadian Tax-Deferred Retirement Savings Accounts Release, *supra* note 294, at n.23 ("The Commission and its staff have interpreted section 7(d) to generally prohibit a foreign fund from making a U.S. private offering if that offering would cause the securities of the fund to be beneficially owned by more than 100 U.S. residents.").

United States" in private funds advised by the adviser; (ii) exempting only those advisers without a place of business "in the United States;" and (iii) exempting only those advisers that do not hold themselves out to the public "in the United States" as an investment adviser.[466] Today, we are defining the term "in the United States" to clarify the term for all of the above purposes as well as to provide specific instructions as to the relevant time for making the related determination.

New rule 202(a)(30)-1 defines "in the United States," as proposed, generally by incorporating the definition of a "U.S. person" and "United States" under Regulation S.[467] In particular, we are defining "in the United States" to mean: (i) with respect to any place of business, any such place that is located in the "United States," as defined in Regulation S;[468] (ii) with respect to any client or private fund investor in the United States, any person who is a "U.S. person" as defined in Regulation S,[469] except that any discretionary account or similar account that is held for the benefit of a person "in the United States" by a non-U.S. dealer or other professional fiduciary is deemed "in the United States" if the dealer or professional fiduciary is a related person of the investment adviser relying on the exemption; and (iii) with respect to the public, in the "United States," as defined in Regulation S.[470]

We believe that the use of Regulation S is appropriate for purposes of the foreign private adviser exemption because Regulation S provides more specific rules when applied to various

466 *See* section 402 of the Dodd-Frank Act.

467 Rule 202(a)(30)-1(c)(3). As discussed above, we are also referencing Regulation S's definition of a "U.S. person" for purposes of the definition of "United States person" in rule 203(m)-1. *See supra* Section II.B.4.

468 *See* 17 CFR 230.902(l).

469 *See* 17 CFR 230.902(k).

470 *See* 17 CFR 230.902(l).

types of legal structures.[471] Advisers, moreover, already apply the Regulation S definition of U.S. person with respect to both clients and investors for other purposes and therefore are familiar with the definition.[472] The references to Regulation S with respect to a place of business "in the United States" and the public in the "United States" also allows us to maintain consistency across our rules. Two commenters specifically supported our approach.[473]

Similar to our approach in new rule 203(m)-1(d)(8) and as we proposed,[474] we are treating as persons "in the United States" for purposes of the foreign private adviser exemption certain persons that would not be considered "U.S. persons" under Regulation S. For example, we are treating as "in the United States" any discretionary account owned by a U.S. person and managed by a non-U.S. affiliate of the adviser in order to discourage non-U.S. advisers from creating such discretionary accounts with the goal of circumventing the exemption's limitation with respect to advising assets of persons in the United States.[475]

We also are including the note to paragraph (c)(3)(i) specifying that for purposes of that definition, a person who is "in the United States" may be treated as not being "in the United

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[471] *See supra* notes 404-407 and accompanying text.

[472] As we noted in the Proposing Release, many non-U.S. advisers identify whether a client is a "U.S. person" under Regulation S in order to determine whether the client may invest in certain private funds and certain private placement offerings exempt from registration under the Securities Act. *See* Proposing Release, *supra* note 26, at n.259. With respect to "investors," our staff has generally taken the interpretive position that an investor that does not meet that definition is not a U.S. person when determining whether a non-U.S. private fund meets the section 3(c)(1) and 3(c)(7) counting or qualification requirements. *See id.*, at n.217. Many non-U.S. advisers, moreover, currently determine whether a private fund investor is a "U.S. person" under Regulation S for purposes of the safe harbor for offshore offers and sales.

[473] Dechert Foreign Adviser Letter; Dechert General Letter. Commenters generally addressed our proposal to rely on Regulation S to identify U.S. persons within the context of the private fund adviser exemption. *See supra* Section II.B.4.

[474] *See supra* Section II.B.4 (discussing the definition of United States persons and the treatment of discretionary accounts).

[475] Rule 202(a)(30)-1(c)(3)(i). *See supra* note 409.

States" if the person was not "in the United States" at the time of becoming a client or, in the case of an investor in a private fund, each time the investor acquires securities issued by the fund.[476] As we explained in the Proposing Release, the note is designed to reduce the burden of having to monitor the location of clients and investors on an ongoing basis, and to avoid placing an adviser in a position whereby it might have to choose between registering with the Commission or terminating the relationship with any client that moved to the United States, or redeeming the interest in the private fund of any investor that moved to the United States.[477]

Several commenters supported the inclusion of the note.[478] Some commenters, however, advocated expanding the note to treat a private fund investor in the same way as a client so that additional investments in a fund made after moving to the United States would not cause the investor to become a U.S. person.[479] They argued that, as discussed above, advisers to non-U.S. funds should not be required to "look through" these funds to ensure that their investors who purchased shares while outside of the United States did not subsequently relocate to the United States and purchase additional shares.

As we explain above, if an adviser reasonably believes that an investor is not "in the United States," the adviser may treat the investor as not being "in the United States." In

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476 Rule 202(a)(30)-1, at note to paragraph (c)(3)(i) ("A person who is in the United States may be treated as not being in the United States if such person was not in the United States at the time of becoming a client or, in the case of an investor in a private fund, each time the investor acquires securities issued by the fund."). We revised the note to provide that it applies "each time" the investor acquires securities issued by the fund. *Cf.* proposed rule 202(a)(30)-1, at note to paragraph (c)(2)(i). This change to the note as proposed more clearly reflects the note's intended operation.

477 *See* Proposing Release, *supra* note 26, at n.257 and accompanying and following text.

478 *See*, *e.g.*, Dechert General Letter ("The note provides helpful relief at a time when advisory clients often move across international borders while keeping an existing relationship with a financial institution."). *See also* ABA Letter; Dechert Foreign Adviser Letter.

479 *See* Dechert Foreign Adviser Letter; Dechert General Letter; EFAMA Letter.

addition, we understand that, based on no-action positions taken by our staff, non-U.S. funds do not consider for purposes of section 3(c)(1) beneficial owners who were not U.S. persons at the time they invested in the fund, but do consider those beneficial owners if they make additional purchases in the same fund after relocating to the United States.[480] The note is consistent with the funds' current practices, and thus generally should not impose any new burdens on non-U.S. funds. The note also is consistent with section 3(c)(7), which requires an investor to be a qualified purchaser at the time the investor acquires the securities.

The Investment Funds Institute of Canada (IFIC) and the Investment Industry Association of Canada (IIAC) urged that, for purposes of the look-through provision, the Commission allow non-U.S. advisers not to count persons (and their assets) who invest in a foreign private fund through certain Canadian retirement accounts ("Participants") after having moved to the United States.[481] The commenters noted that this treatment would be consistent with rule 7d-2 under the Investment Company Act and certain related rules.[482] We agree. A non-U.S. fund sold to Participants would be deemed a private fund if it conducted a private

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480 *See* Investment Funds Institute of Canada, SEC Staff No-Action Letter (Mar. 4, 1996) (staff also stated its belief that, to the extent that a dividend reinvestment plan of a non-U.S. fund is consistent with the requirements of Securities Act Release No. 929 (July 29, 1936), such a plan would not involve an offer for purposes of Section 7(d) of the Investment Company Act). *See also* Goodwin Procter No-Action Letter, *supra* note 294; Touche Remnant No-Action Letter, *supra* note 294.

481 *See* IFIC Letter; Comment Letter of Investment Industry Association of Canada (Jan. 18, 2011) ("IIAC Letter").

482 We adopted rule 7d-2, along with rule 237 under the Securities Act, in order to allow Participants who move to the United States to continue to manage their Canadian retirement accounts. *See Offer and Sale of Securities to Canadian Tax-Deferred Retirement Savings Accounts*, Securities Act Release No. 7860 (June 7, 2000) [65 FR 37672 (June 15, 2000)]. U.S. registration requirements were affecting those Participants' ability to purchase or exchange securities for such accounts. Rule 7d-2 generally allows non-U.S. funds to treat as a private offering certain offerings to Participants who are in the United States.

offering in the United States,[483] but we have previously stated that Participants need not be counted toward the 100-investor limit for purposes of section 3(c)(1).[484] As a result, and based on the same policy considerations embodied in rule 7d-2, we believe that a non-U.S. adviser should not be required to treat Participants as investors in the United States under rule 202(a)(30)-1 with respect to investments they make after moving to the United States if the fund is in compliance with rule 7d-2.[485]

4. Place of Business

New rule 202(a)(30)-1, by reference to rule 222-1,[486] defines "place of business" to mean any office where the investment adviser regularly provides advisory services, solicits, meets with, or otherwise communicates with clients, and any location held out to the public as a place where the adviser conducts any such activities.[487] We are adopting this provision as proposed because we believe the definition appropriately identifies a location where an adviser is doing business for purposes of section 202(a)(30) of the Advisers Act and thus provides a basis for an adviser to determine whether it can rely on the exemption in section 203(b)(3) of the Advisers Act for foreign private advisers. As discussed in the Proposing Release, because both the Commission and the state securities authorities use this definition to identify an unregistered

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483 *See supra* notes 294 and 313.

484 *See* Canadian Tax-Deferred Retirement Savings Accounts Release, *supra* note 294, at n.23.

485 This interpretation only applies with respect to Participants' investments in Eligible Securities issued by a Qualified Company, as these terms are defined in rule 7d-2.

486 Rule 222-1(a) (defining "place of business" of an investment adviser as: "(1) An office at which the investment adviser regularly provides investment advisory services, solicits, meets with, or otherwise communicates with clients; and (2) Any other location that is held out to the general public as a location at which the investment adviser provides investment advisory services, solicits, meets with, or otherwise communicates with clients.").

487 Rule 202(a)(30)-1(c)(4).

foreign adviser's place of business for purposes of determining regulatory jurisdiction,[488] we believe it is logical as well as efficient to use the rule 222-1(a) definition of "place of business" for purposes of the foreign private adviser exemption. The two commenters that considered the proposed definition of "place of business" by reference to rule 222-1 agreed with this analysis.[489]

Some commenters asked us to clarify that a "place of business" would not include an office in the United States where a non-U.S. adviser solely conducts research, communicates with non-U.S. clients, or performs administrative services and back-office books and recordkeeping activities.[490] Under rule 202(a)(30)-1, as under rule 203(m)-1, an adviser must determine whether it has a place of business, as defined in rule 222-1, in the United States in light of the relevant facts and circumstances.[491] For example, any office from which an adviser regularly communicates with its clients, whether U.S. or non-U.S., would be a place of business.[492] In addition, an office or other location where an adviser regularly conducts research would be a place of business because research is intrinsic to the provision of investment advisory services.[493] A place of business would not, however, include an office where an adviser solely performs administrative services and back-office activities if they are not activities intrinsic to

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488 *See* Proposing Release, *supra* note 26, at n.265 (explaining that, under section 222(d) of the Advisers Act, a state may not require an adviser to register if the adviser does not have a "place of business" within, and has fewer than six clients resident in, the state).

489 *See* ABA Letter ("[W]e believe that the definition of place of business set forth in Rule 222-1 is appropriate . . . ."); AIMA Letter ("We consider the definition of 'place of business' by reference to Rule 222-1 of the Advisers Act both logical and appropriate.").

490 *See, e.g.*, ABA Letter; AIMA Letter.

491 As discussed above, investment advisers will also apply this provision for purposes of the private fund adviser exemption. *See supra* Section II.B.3.

492 Rule 222-1 does not distinguish between U.S. and non-U.S. clients.

493 That would include, for example, research conducted in order to produce non-public information relevant to the investments of, or the investment recommendations for, any of the adviser's clients.

providing investment advisory services and do not involve communicating with clients.

A number of commenters sought guidance as to whether the activities of U.S. affiliates of non-U.S. advisers would be deemed to constitute places of business in the United States of the non-U.S. advisers.[494] There is no presumption that a non-U.S. adviser has a place of business in the United States solely because it is affiliated with a U.S. adviser.[495] A non-U.S. adviser might be deemed to have a place of business in the United States, however, if the non-U.S. adviser's personnel regularly conduct activities at an affiliate's place of business in the United States.[496]

5. Assets Under Management

For purposes of rule 202(a)(30)-1 we are defining "assets under management," as proposed, by reference to the calculation of "regulatory assets under management" for Item 5 of Form ADV.[497] As discussed above, in Item 5 of Form ADV we are implementing a uniform method of calculating assets under management that can be used for several purposes under the Advisers Act, including the foreign private adviser exemption and the private fund adviser

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494 *See*, *e.g.*, Debevoise Letter; Dechert Foreign Adviser Letter; EFAMA Letter.

495 S*ee infra* note 506.

496 We have provided guidance as to whether certain activities would result in an investment adviser representative having a place of business as defined in rule 203A-3(b), which we believe also is applicable to an adviser's determination as to whether it has a U.S. place of business under rule 222-1 (and therefore under rule 203(m)-1 or rule 203(a)(30)-1). We have explained that the definition in rule 203A-3(b) "encompasses permanent and temporary offices as well as other locations at which an adviser representative may provide advisory services, such as a hotel or auditorium." *Rules Implementing Amendments to the Investment Advisers Act of 1940*, Investment Advisers Act Release No. 1633 (May 15, 1997) [62 FR 28112 (May 22, 1997)]. We further explained that whether a temporary office or location is a place of business "will turn on whether the adviser representative has let it generally be known that he or she will conduct advisory business at the location, rather than on the frequency with which the adviser representative conducts advisory business there." *Id. See also infra* Section II.D.

497 *See* rule 202(a)(30)-1(c)(1); instructions to Item 5.F of Form ADV, Part 1A. As discussed above, we are taking the same approach under rule 203(m)-1. *See supra* Section II.B.2.a.

exemption.[498] Because the foreign private adviser exemption is also based on assets under management, we believe that all advisers should use the same method for calculating assets under management to determine if they are required to register or may be eligible for the exemption.[499]

We believe that uniformity in the method for calculating assets under management will result in more consistent asset calculations and reporting across the industry and, therefore, in a more coherent application of the Advisers Act's regulatory requirements and assessment of risk.[500] One commenter specifically agreed that the uniform method should be applied for purposes of the foreign private adviser exemption.[501] Most commenters addressed the components of the new method of calculation in reference to the calculation of "regulatory assets under management" under Form ADV, or with respect to the calculation of private fund assets for purposes of the private fund adviser exemption.[502] We address these comments in the Implementing Adopting Release and in Section II.B.2.[503]

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498 *See supra* Section II.B.2.a; Implementing Adopting Release, *supra* note 32, discussion at section II.A.3.

499 According to the statutory definition of "foreign private adviser," a non-U.S. adviser calculating the assets relevant for purposes of the foreign private adviser exemption would only include those assets under management (*i.e.*, regulatory assets under management) that are "attributable to clients in the United States and investors in the United States in private funds advised by the investment adviser." *See supra* notes 416 and 429 and accompanying text and note 417.

500 *See supra* Section II.B.2.a; Implementing Adopting Release, *supra* note 32, discussion at section II.A.3.

501 *See* Seward Letter.

502 *See supra* Section II.B.2.a; Implementing Adopting Release, *supra* note 32, discussion at section II.A.3. A few commenters raised the same arguments in favor of revising the method of calculation also with respect to the calculation under the foreign private adviser exemption. *See, e.g.*, ABA Letter; EFAMA Letter; Katten Foreign Advisers Letter (arguing that the method should exclude proprietary and knowledgeable employee assets, and assets for which the adviser receives no compensation).

503 *See* Implementing Adopting Release, *supra* note 32, discussion at section II.A.3. In addition, several commenters requested that we exercise our authority to increase the $25 million asset

D. Subadvisory Relationships and Advisory Affiliates

We generally interpret advisers as including subadvisers,[504] and therefore believe it is appropriate to permit subadvisers to rely on each of the new exemptions, provided that subadvisers satisfy all terms and conditions of the applicable rule.

We are aware that in many subadvisory relationships a subadviser has contractual privity with a private fund's primary adviser rather than the private fund itself. Although both the private fund and the fund's primary adviser may be viewed as clients of the subadviser, we would consider a subadviser eligible to rely on rule 203(m)-1 if the subadviser's services to the primary adviser relate solely to private funds and the other conditions of the rule are met. Similarly, a subadviser may be eligible to rely on section 203(l) if the subadviser's services to the primary adviser relate solely to venture capital funds and the other conditions of the rule are met.

We anticipated that an adviser with advisory affiliates could encounter interpretative issues as to whether it may rely on any of the exemptions discussed in this Release without taking into account the activities of its affiliates. The adviser, for example, might have advisory affiliates that are registered or that provide advisory services that the adviser itself could not

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threshold applicable to the foreign private adviser exemption. *See, e.g.*, ABA Letter ($100 million); AFG Letter ($150 million); AIMA Letter (at least $100 million); Comment Letter of Autorité des Marchés Financiers (Jan. 18, 2011) ($150 million); EVCA Letter ($100 or $150 million); DLA Piper VC Letter ($250 million); Fulbright Letter ($500 million). We acknowledged in the Proposing Release that Section 204 of the Advisers Act provides us with the authority to raise the threshold, but we did not propose to do so. Therefore, we have not considered raising the threshold in connection with this rulemaking, but we will evaluate whether doing so may be appropriate in the future, consistent with a comment we received. *See* ABA Letter (asked that we "monitor this issue . . . undertake dialogue with foreign regulators with respect to their supervisory regimes over investment advisers, and . . . consider proposing an increase in the exemption amount in the near future").

504 *See, e.g.,* Pay to Play Release, *supra* note 9, at nn.391-94 and accompanying and following text; Hedge Fund Adviser Registration Release, *supra* note 14, at n.243.

provide while relying on an exemption. In the Proposing Release, we requested comment on whether any proposed rule should provide that an adviser must take into account the activities of its advisory affiliates when determining eligibility for an exemption, by having the rule, for example, specify that the exemption is not available to an affiliate of a registered investment adviser.

Commenters that responded to our request for comment generally supported treating each advisory entity separately without regard to the activities of, or relationships with, its affiliates.[505] This approach, however, would for example permit an adviser managing $200 million in private fund assets simply to reorganize as two separate advisers, each of which could purport to rely on the private fund adviser exemption. Such a result would in our view be inconsistent with the intent of Congress in establishing the exemption's $150 million threshold and would violate section 208(d) of the Advisers Act, which prohibits any person from doing indirectly or through or by any other person any act or thing which would be unlawful for such person to do directly. Accordingly, we would treat as a single adviser two or more affiliated advisers that are separately organized but operationally integrated, which could result in a requirement for one or both advisers to register.[506] Some commenters acknowledged this, but urged that, in the case of a non-U.S. advisory affiliate, the Commission affirm the staff's positions developed in the

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[505] *See, e.g.*, AFG Letter (in determining exemption thresholds, each entity's assets should be determined separately; does not support combining different entities with different business activities); Debevoise Letter (in the context of rule 203(m)-1).

[506] Generally, a separately formed advisory entity that operates independently of an affiliate may be eligible for an exemption if it meets all of the criteria set forth in the relevant rule. However, the existence of separate legal entities may not by itself be sufficient to avoid integration of the affiliated entities. The determination of whether the advisory businesses of two separately formed affiliates may be required to be integrated is based on the facts and circumstances. Our staff has taken this position in Richard Ellis, Inc., SEC Staff No-Action Letter (Sept. 17, 1981) (discussing the staff's views of factors relevant to the determination of whether a separately formed advisory entity operates independently of an affiliate). *See also* discussion *infra* following note 515.

Unibanco line of no-action letters ("*Unibanco* letters").[507] In the *Unibanco* letters,[508] the staff provided assurances that it would not recommend enforcement action, subject to certain conditions, against a non-U.S. unregistered adviser that is affiliated with a Commission-registered adviser, despite sharing personnel and resources.[509]

The *Unibanco* letters grew out of recommendations in a 1992 staff study, and sought to limit the extraterritorial application of the Advisers Act while also protecting U.S. investors and markets.[510] In these letters, the staff provided assurances that it would not recommend

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507 *See, e.g.*, AIMA Letter, Commenter Letter of Bank of Montreal, Royal Bank of Canada and The Toronto-Dominion Bank (Jan. 24, 2011) ("Canadian Banks Letter"); CompliGlobe Letter; Debevoise Letter; Dechert General Letter (also supported extending the *Unibanco* letters to U.S. advisers); Dechert Foreign Adviser Letter; EFAMA Letter; Katten Foreign Advisers Letter; McGuireWoods Letter; MFA Letter; Comment Letter of MFS Investment Management (Jan. 24, 2011) ("MFS Letter"); Comment Letter of Ropes & Gray LLP (Jan. 24, 2011).

508 *See, e.g.*, ABA Subcommittee on Private Investment Entities, SEC Staff No-Action Letter (Dec. 8, 2005) ("ABA No-Action Letter"); Royal Bank of Canada, SEC Staff No-Action Letter (Jun. 3, 1998); ABN AMRO Bank, N.V., SEC Staff No-Action Letter (Jul. 7, 1997); Murray Johnstone Holdings Limited, SEC Staff No-Action Letter (Oct. 7, 1994); Kleinwort Benson Investment Management Limited, SEC Staff No-Action Letter (Dec. 15, 1993); Mercury Asset Management plc, SEC Staff No-Action Letter (Apr. 16, 1993); and Uniao de Bancos de Brasileiros S.A., SEC Staff No-Action Letter (Jul. 28, 1992) ("Unibanco No-Action Letter"). *See also* 1992 Staff Report, *supra* note 393, at Section III.D.

509 Generally, the staff has provided assurances that it will not recommend enforcement action in situations in which the unregistered non-U.S. adviser, often termed a "participating affiliate" in these letters, and its registered affiliate are separately organized; the registered affiliate is staffed with personnel (located in the U.S. or abroad) who are capable of providing investment advice; all personnel of the participating affiliate involved in U.S. advisory activities are deemed "associated persons" of the registered affiliate; and the Commission has adequate access to trading and other records of the participating affiliate and to its personnel to the extent necessary to enable it to identify conduct that may harm U.S. clients or markets. *See supra* note 508; Hedge Fund Adviser Registration Release, *supra* note 14, at n.211 and accompanying text.

510 *See* 1992 Staff Report, *supra* note 393, at section III.D. In enacting the private fund adviser exemption and the foreign private adviser exemption, both of which focus on an adviser's activities in, or contacts with, the United States, Congress has addressed issues similar to those described in the 1992 Staff Report. *See* section 408 of the Dodd-Frank Act (directing the Commission to exempt private fund advisers with less than "$150 million in assets under management *in the United States*") (emphasis added); sections 402 and 403 of the Dodd-Frank Act (exempting from registration foreign private advisers with no *place of business in the United States* that have a limited number of *clients in the United States and investors in the United States*

enforcement action of the substantive provisions of the Advisers Act with respect to a non-U.S. adviser's relationships with its non-U.S. clients.[511] In addition, and as relevant here, the staff agreed not to recommend enforcement action if a non-U.S. advisory affiliate of a registered adviser, often termed a "participating affiliate," shares personnel with, and provides certain services through, the registered adviser affiliate, without such affiliate registering under the Advisers Act.[512] Many commenters asserted that affirming these positions would accommodate established business practices of global advisory firms without reducing the Commission's ability to protect U.S. markets and investors, because the Commission would continue to have access to records and personnel of unregistered non-U.S. advisory entities that are involved in the U.S. advisory business of an affiliated and registered adviser.[513]

A number of commenters asserted that the staff positions in the *Unibanco* letters are consistent with our approach to the territorial application of the Advisers Act with respect to non-U.S. advisers.[514] As we stated in 2004, we do not apply most of the substantive provisions of the Advisers Act to the non-U.S. clients of a non-U.S. adviser registered with the Commission.[515] However, the *Unibanco* letters were developed by the staff in the context of the

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in private funds and a limited amount of assets attributable to these clients and investors, among other conditions).

511 *See supra* note 508. *See also infra* note 515.

512 *See supra* note 508.

513 *See, e.g.,* Canadian Banks Letter; CompliGlobe Letter; MFA Letter; MFS Letter.

514 *See, e.g.*, Canadian Banks Letter; MFA Letter. *See also supra* notes 510 and 316 and accompanying text.

515 *See* Hedge Fund Adviser Registration Release, *supra* note 14, at nn.211 and 216-222 and accompanying text (noting that this policy was first set forth in the Unibanco No-Action Letter). Although the rules contained in the Hedge Fund Adviser Registration Release were vacated by a federal court in *Goldstein, supra* note 14, the court's decision did not address our statement in that release that we do not apply most of the substantive provisions of the Advisers Act to the non-U.S. clients of a non-U.S. adviser registered with the Commission. In addition, our staff

private adviser exemption,[516] which Congress repealed. Nothing in the rules we are today adopting in this Release is intended to withdraw any prior statement of the Commission or the views of the staff as expressed in the *Unibanco* letters. We expect that the staff will provide guidance, as appropriate, based on facts that may be presented to the staff regarding the application of the *Unibanco* letters in the context of the new foreign private adviser exemption and the private fund adviser exemption.

III. CERTAIN ADMINISTRATIVE LAW MATTERS

The effective date for rules 203(l)-1, 203(m)-1 and 202(a)(30)-1 is July 21, 2011. The Administrative Procedure Act generally requires that an agency publish a final rule in the Federal Register not less than 30 days before its effective date.[517] This requirement does not apply, however, if the rule is a substantive rule which grants or recognizes an exemption or relieves a restriction or is an interpretative rule.[518]

As discussed above, effective July 21, 2011, the Dodd-Frank Act amends the Advisers

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expressed this view in a 2006 no-action letter issued in response to a request for the staff's views on matters affecting investment advisers to certain private funds that arose as a result of the *Goldstein* decision. *See* ABA Subcommittee on Private Investment Companies, SEC Staff No-Action Letter (Aug. 10, 2006) (Commission staff expressed the view that the substantive provisions of the Advisers Act do not apply to offshore advisers with respect to such advisers' dealings with offshore funds and other offshore clients to the extent described in prior staff no-action letters and the Hedge Fund Adviser Registration Release, *supra* note 14. The staff noted, however, that an offshore adviser registered with the Commission under the Advisers Act must comply with the Advisers Act and the Commission's rules thereunder with respect to any U.S. clients (and any prospective U.S. clients) it may have.).

516 Our staff has provided assurances that it would not recommend enforcement action when no participating affiliate has any U.S. clients other than clients of the registered affiliate, consistent with the private adviser exemption, which was conditioned on the number of a non-U.S. adviser's U.S. clients. *See supra* notes 508-509; Hedge Fund Adviser Registration Release, *supra* note 14, at n.211 and accompanying text. Under the *Unibanco* letters, participating affiliates only share personnel with, and provide certain services through, their registered adviser affiliates. *See supra* notes 508-509.

517 *See* 5 U.S.C. 553(d).

518 The statute also provides an exception if the agency finds good cause to make the rule effective less than 30 days after its date of publication in the Federal Register. *Id.*

Act to eliminate the private adviser exemption in pre-existing section 203(b)(3), which will require advisers relying on that exemption to register with the Commission as of July 21, 2011 unless another exemption is available.[519] Also effective July 21, 2011, are the Dodd-Frank Act amendments to the Advisers Act that are described immediately below.

Sections 203(l) and 203(b)(3) of the Advisers Act provide exemptions from registration for advisers to venture capital funds and foreign private advisers, respectively. Rule 203(l)-1 defines venture capital fund, and rule 202(a)(30)-1 defines several terms in the definition of "foreign private adviser" in section 202(a)(30).[520] Thus, these interpretive rules implement the new venture capital and foreign private adviser exemptions added to the Advisers Act by the Dodd-Frank Act.

Section 203(m) of the Advisers Act, as amended by the Dodd-Frank Act, directs the Commission to provide an exemption for advisers solely to private funds with assets under management in the United States of less than $150 million. Rule 203(m)-1, which implements section 203(m), grants an exemption and relieves a restriction and in part has interpretive aspects. Accordingly, we are making the rules effective on July 21, 2011.

IV. PAPERWORK REDUCTION ANALYSIS

The rules do not contain a "collection of information" requirement within the meaning of the Paperwork Reduction Act of 1995.[521] Accordingly, the Paperwork Reduction Act is not applicable.

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519 *See* sections 403 of the Dodd-Frank Act; sections 203(b)(3) of the Advisers Act; Section I *supra*.

520 As discussed above, the Dodd-Frank Act amended the Advisers Act to define "foreign private adviser" in section 202(a)(30).

521 44 U.S.C. 3501.

V. COST-BENEFIT ANALYSIS

As discussed above, we are adopting rules 203(l)-1, 203(m)-1 and 202(a)(30)-1 to implement certain provisions of the Dodd-Frank Act. As a result of the Dodd-Frank Act's repeal of the private adviser exemption, some advisers that previously were eligible to rely on that exemption will be required to register under the Advisers Act unless they are eligible for a new exemption. Thus, the benefits and costs associated with registration for advisers that are not eligible for an exemption are attributable to the Dodd-Frank Act.[522] Moreover, the Dodd-Frank Act provides that, unlike an adviser that is specifically exempt pursuant to section 203(b), an adviser relying on an exemption provided by section 203(l) of the Advisers Act or rule 203(m)-1 thereunder may be subject to reporting and recordkeeping requirements.[523] Hence, the benefits and costs associated with being an exempt reporting adviser, relative to being an adviser that is registered or specifically exempted by reason of section 203(b), are attributable to the Dodd-Frank Act. The Commission has discretion, however, to adopt rules to define the terms used in the Advisers Act, and we undertake below to discuss the benefits and costs of the rules that we are adopting to implement the exemptions discussed in this Release.[524]

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522 As we discuss above, although most venture capital advisers agreed with our proposed approach to the definition of venture capital fund, a number of commenters disagreed with our approach to the proposed definition, and argued that it should be expanded to include investments in small companies (regardless of whether they satisfy our definition of qualifying portfolio company) and investments in other private funds. *See, e.g.*, NASBIC/SBIA Letter; PEI Funds/Willowbridge Letter; VIA Letter. We do not believe that these more expansive positions are consistent with the intended scope of the venture capital exemption as expressed by Congress. *See supra* note 204 and accompanying text. Thus, we believe that the costs of registration for advisers to funds that would not satisfy the definition because they hold such investments are attributable to the Dodd-Frank Act.

523 *See supra* note 5.

524 The benefits and costs of the reporting requirements applicable to advisers relying on the venture capital exemption and the private fund adviser exemption are discussed in greater detail in the Implementing Adopting Release, *supra* note 32, discussion at sections V.A.2 and V.B.2.

We are sensitive to the costs and benefits imposed by our rules, and understand that there will be costs and benefits associated with complying with the rules we are adopting today. We recognize that certain aspects of these rules may place burdens on advisers that seek to qualify for the various exemptions discussed in this Release. We believe that these rules, as modified from the proposals, offer flexibility and clarity for advisers seeking to qualify for the exemptions. We have designed the rules to balance these concerns with respect to potential costs and burdens with what we understand was intended by Congress.

In the Proposing Release, we identified possible costs and benefits of the proposed rules and requested comment on the analysis, including identification and assessment of any costs and benefits not discussed in the analysis. We requested that commenters provide analysis and empirical data to support their views on the costs and benefits associated with the proposals. In addition, we requested confirmation of our understanding of how advisers that may seek to rely on the exemptions operate and manage private funds and how the proposals may affect them and their businesses.

A. Definition of Venture Capital Fund

We define a venture capital fund as a private fund that: (i) holds no more than 20 percent of the fund's capital commitments in non-qualifying investments (other than short-term holdings) ("qualifying investments" generally consist of equity securities of "qualifying portfolio companies" and are discussed below); (ii) does not borrow or otherwise incur leverage, other than limited short-term borrowing (excluding certain guarantees of qualifying portfolio company obligations by the fund); (iii) does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; (iv) represents itself as pursuing a venture capital strategy to investors; and (v) is not registered under the Investment Company Act and has not elected to be treated as a BDC.[525]

We define "qualifying investments" as: (i) directly acquired equities; (ii) equity securities issued by a qualifying portfolio company in exchange for directly acquired equities issued by the same qualifying portfolio company; and (iii) equity securities issued by a company of which a qualifying portfolio company is a majority-owned subsidiary, or a predecessor, and is received in exchange for directly acquired equities of the qualifying portfolio company (or securities exchanged for such directly acquired equities).[526] We define a "qualifying portfolio company" as any company that: (i) is not a reporting company and does not have a control relationship with a reporting company; (ii) does not borrow or issue debt obligations in connection with the investment by the private fund and distribute proceeds of the borrowing or issuance to the private fund in exchange for the private fund investment; and (iii) is not itself a fund (*i.e.*, is an operating company).[527]

The final rule also grandfathers existing funds by including in the definition of "venture capital fund" any private fund that: (i) represented to investors and potential investors at the time the fund offered its securities that it pursues a venture capital strategy; (ii) prior to December 31, 2010, has sold securities to one or more investors that are not related persons of any investment adviser of the venture capital fund; and (iii) does not sell any securities to, including accepting any additional capital commitments from, any person after July 21, 2011 (the "grandfathering provision").[528] An adviser seeking to rely on the exemption under section 203(l) of the Advisers Act would be eligible for the venture capital exemption only if it exclusively advised venture

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525 Rule 203(l)-1(a).

526 Rule 203(l)-1(c)(3).

527 Rule 203(l)-1(c)(4). *See also* text accompanying note 148.

528 Rule 203(l)-1(b).

capital funds that satisfy all of the elements of the definition of venture capital fund or the grandfathering provision.

We have identified certain costs and benefits, discussed below, that may result from our definition of venture capital fund, including modifications to the proposal. As we discussed in the Proposing Release, the proposed rule was designed to: (i) implement the directive from Congress to define the term venture capital fund in a manner that reflects Congress' understanding of what venture capital funds are, and as distinguished from other private funds such as private equity funds and hedge funds; and (ii) facilitate the transition to the new exemption.[529] As discussed above, we have modified the proposed rule to give qualifying funds greater flexibility with respect to their investments, partly in response to comments we received.[530] The final rule defines the term venture capital fund consistently with what we believe Congress understood venture capital funds to be,[531] and in light of other concerns expressed by Congress with respect to the intended scope of the venture capital exemption.[532]

Approximately 26 comment letters addressed the costs and benefits of the proposed rule defining venture capital fund.[533] As discussed below, most of these commenters did not provide empirical data to support their views. However, a number of venture capital advisers commenting on the proposed rule offered observations based upon their experiences managing venture capital funds and presented views on the potential impact of the proposed rule on their

529 *See* Proposing Release, *supra* note 26, discussion at text immediately preceding text accompanying n.273.

530 *See generally* Section II.A.1.

531 *See supra* notes 36-37 and accompanying and following text. *See also infra* note 535.

532 *See supra* discussion at Section II.A.

533 *See, e.g.*, NVCA Letter; NYSBA Letter; Oak Investments Letter; Sevin Rosen Letter; SVB Letter; Trident Letter.

businesses and business practices.

1. Benefits

In the Proposing Release, we stated that based on the testimony presented to Congress and our research, we believed that venture capital funds currently in existence would meet most, if not all, of the elements of our proposed definition of venture capital fund.[534] Several commenters agreed that the proposed rule is consistent with Congressional intent.[535] Many venture capital advisers and related industry groups acknowledged that the proposed definition would generally encompass most venture capital investing activity that typically occurs,[536] but expressed the concern that a venture capital fund may, on occasion, deviate from its typical investing pattern with the result that the fund could not satisfy all of the definitional criteria under the proposed rule with respect to each investment all of the time.[537] Several commenters also expressed the concern that the final rule should provide sufficient flexibility to accommodate future business practices that are not known or contemplated today.[538]

For the reasons discussed above, we have modified the definition of venture capital fund.

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534 Proposing Release, *supra* note 26, at section IV.A.1.

535 AFL-CIO Letter ("[T]he SEC has . . . generally provided appropriate definitions for each of the factors."); AFR Letter ("[W]e believe that the exemption ultimately created in the [Dodd-Frank Act] for venture capital funds must be narrowly defined so as to prevent it from undermining the requirement all other fund managers register. We believe that the language in the proposed rule meets this goal . . ."); Sen. Levin Letter ("[T]he proposed definition captures the essence of venture capital firms whose mission is to encourage the development and expansion of new business."). *See also* DuFauchard Letter ("Congressional directives require the SEC to exclude private equity funds, or any fund that pivots its investment strategy on the use of debt or leverage, from the definition of VC Fund.").

536 *See, e.g.*, Cook Children's Letter ("The Commission's definition of a venture capital fund does a thorough job capturing many of the aspects that differentiate venture capital funds from other types of private investment funds."); Leland Fikes Letter; NVCA Letter ("[T]he Proposed Rules are generally consistent with existing venture capital industry practice . . ."). *See also* CompliGlobe Letter; DLA Piper VC Letter.

537 *See, e.g.*, ATV Letter; BIO Letter; NVCA Letter; Sevin Rosen Letter.

538 *See, e.g.*, NVCA Letter; Oak Investments Letter.

Our modifications include specifying a non-qualifying basket[539] and excluding from the 120-day limit with respect to leverage certain guarantees of portfolio company obligations by a qualifying fund.[540] For the reasons discussed in greater detail above, we are adopting a limit of 20 percent for non-qualifying investments.[541] In summary, the non-qualifying basket is designed to address commenters' concerns regarding occasional deviations from typical venture capital investing activity,[542] inadvertent violations of the definitional criteria[543] and flexibility to address evolving or future business practices.[544] We considered these comments in light of our concerns that the exemption not be expanded beyond what we believe was the intent of Congress[545] and that the definition not operate to foreclose investment funds from investment opportunities that would benefit investors but would not change the character of the fund.[546] We concluded that a non-qualifying basket limit of 20 percent would provide the flexibility sought by many venture capital fund commenters while appropriately limiting the scope of the exemption.[547]

We believe that the final rule (including the modifications from the proposal) better describes the existing venture capital industry and provides venture capital advisers with greater flexibility to accommodate existing (and potentially evolving or future) business practices and take advantage of investment opportunities that may arise. We also believe that the criteria

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539 Rule 203(l)-1(a)(2).

540 Rule 203(l)-1(a)(3).

541 *See generally* Section II.A.

542 *See supra* note 56.

543 *See supra* note 58.

544 *See supra* note 56.

545 *See supra* notes 45 and 61 and accompanying text.

546 *See supra* note 60.

547 *See supra* note 72 and following text.

under the final rule will facilitate transition to the new exemption, because it minimizes the extent to which an adviser seeking to rely on the venture capital exemption would need to alter its existing business practices, thus, among other things, reducing the likelihood of inadvertent non-compliance.[548]

As we discuss in greater detail above, many commenters arguing in favor of the modifications that we are adopting generally cited these benefits to support their views.[549] Specifically, several commenters asserted that providing a limited basket for non-qualifying investments would benefit venture capital advisers relying on the venture capital exemption, and the U.S. economy, by facilitating job creation and capital formation[550] and minimizing the extent to which a venture capital fund would need to alter its typical business practices.[551] Other commenters maintained that an approach providing advisers some flexibility on occasion to take advantage of promising investment opportunities that might not be typical of most venture capital activity would benefit those funds and their investors.[552]

We anticipate that a number of benefits, described by commenters, may result from

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548 For example, the final rule does not specify that a qualifying fund must provide managerial assistance or control each qualifying portfolio company in which the fund invests. A number of commenters indicated that venture capital funds may not provide sufficient assistance or exercise sufficient control in order to satisfy this element of the proposed definition. *See, e.g.*, ESP Letter; Merkl Letter. The final rule also allows a qualifying fund to exclude investments in money market funds from the non-qualifying basket. A number of commenters indicated that money market funds are typically used by venture capital funds for cash management purposes. *See, e.g.*, NVCA Letter. We expect that these modifications to the rule would avoid the cost of altering an adviser's existing business practices.

549 *See, e.g.*, NVCA Letter; Oak Investments Letter; Quaker BioVentures Letter. *See also supra* discussion at Section II.A.1.

550 *See, e.g.*, NVCA Letter (stating that a low level of 15% would "allow innovation and job creation to flourish within the venture capital industry"); Sevin Rosen Letter (a 20% limit would be "flexible enough not to severely impair the operations of bona fide [venture capital funds], a critically important resource for American innovation and job creation").

551 *See, e.g.*, McDonald Letter; Pine Brook Letter.

552 *See, e.g.*, DuFauchard Letter; Merkl Letter.

allowing qualifying funds limited investments in non-qualifying investments, including publicly traded securities, securities that are not equity securities (*e.g.*, non-convertible debt instruments) and interests in other private funds.[553] For example, increasing the potential pool of investors that could provide financing to publicly traded companies to include venture capital funds could facilitate access to capital for a portfolio company's expansion and growth.[554] Including investments that are not equity securities could offer funds seeking to qualify as venture capital funds the flexibility to structure an investment in a manner that is most appropriate for the fund (and its investors), including for example to obtain favorable tax treatment, manage risks (such as bankruptcy protection), maintain the value of the fund's equity investment or satisfy the specific financing needs of a portfolio company.[555] Including non-convertible bridge financing also would enable a portfolio company to seek such financing from venture capital funds if it is unable to obtain financing from traditional lending sources.[556] In addition, permitting qualifying funds to invest in other underlying private funds could facilitate capital formation and enhance liquidity for the underlying private funds.[557] Under the final rule, qualifying funds also would have increased flexibility to invest in portfolio companies through secondary market transactions. Commenters asserted that this would help align the interests of portfolio company founders with the interests of venture capital funds[558] and prevent dilution of the venture capital

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553 Rule 203(l)-1(a)(2) (specifying that a qualifying fund must hold, immediately after the acquisition of any asset (excluding short-term holdings) no more than 20% of its committed capital in assets that are not qualifying investments); rule 203(l)-1(c)(3) (defining "qualifying investment").

554 *See, e.g.*, Lowenstein Letter; McDonald Letter; Mesirow Letter; Quaker BIO Letter; Trident Letter.

555 *See, e.g.*, Merkl Letter; Oak Investments Letter; Sevin Rosen Letter; Vedanta Capital Letter.

556 NVCA Letter; Trident Letter.

557 *See, e.g.*, Cook Children's Letter; Leland Fikes Letter; Merkl Letter; SVB Letter.

558 Sevin Rosen Letter.

fund's investment in the portfolio company.[559]

Under the final rule, the non-qualifying basket is determined as a percentage of a qualifying fund's capital commitments, and compliance with the 20 percent limit is determined each time a qualifying fund makes any non-qualifying investment (excluding short-term holdings). We expect that calculating the size of the non-qualifying basket as a percentage of a qualifying fund's capital commitments, which will remain relatively constant during the fund's term, will provide advisers with a degree of predictability when managing the fund's portfolio and determining how much of the basket remains available for new investments. Moreover, we believe that by applying the 20 percent limit as of the time of acquisition of each non-qualifying investment, a fund is able to determine prospectively how much it can invest in the non-qualifying basket. We believe that this approach to determining the non-qualifying basket will appropriately limit a qualifying fund's non-qualifying investments and ease the burden of determining compliance with the criterion under the rule.

As discussed above, a qualifying fund can only invest up to 20 percent of its capital commitments in non-qualifying investments, as measured immediately after it acquires any non-qualifying investment.[560] The final rule treats as a qualifying investment any equity security of a qualifying portfolio company, or a company acquiring the qualifying portfolio company, that is exchanged for directly acquired equities issued by the qualifying portfolio company. This definition should benefit venture capital funds because it allows funds to participate in the

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559 SVB Letter.

560 The rule requires a qualifying fund at the time it acquires an asset, to have no more than 20% of its capital commitments invested in assets that are not qualifying investments. Rule 203(l)-1(a)(2).

reorganization of the capital structure of a portfolio company.[561] It also provides qualifying funds with liquidity and an opportunity to take profits from their investments because they can acquire securities in connection with the acquisition (or merger) of a qualifying portfolio company by another company — typical means by which venture capital funds exit an investment.[562]

The final rule excludes from the 120-day limit with respect to leverage any venture capital fund guarantees of portfolio company indebtedness, up to the value of the fund's investment in the company.[563] We agree with several commenters who stated that guarantees of portfolio company indebtedness under these circumstances will facilitate a portfolio company's ability to obtain credit for working capital or business operations.[564] Thus, we believe this provision, which is designed to accommodate existing business practices typical of venture capital funds, may contribute to efficiency, competition and capital formation.

The final rule excludes from the definition of qualifying portfolio company any company that borrows or issues debt if the proceeds of such borrowing or debt are distributed to the venture capital fund in exchange for the fund's investment in the company. This will allow qualifying funds to provide financing on a short-term basis to portfolio companies as a "bridge"

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561 *See supra* note 109 and following text.

562 *See, e.g.*, NVCA Letter; PTV Sciences Letter. The final rule defines equity securities broadly to cover many types of equity securities in which venture capital funds typically invest, rather than limit the definition solely to common stock. *See supra* notes 95-96 and accompanying text. Our definition of qualifying portfolio company is similarly broad because it does not restrict qualifying companies to "small or start-up" companies. As we have noted in the Proposing Release and above, we believe that such definitions would be too restrictive and provide venture capital fund advisers with too little flexibility and limited options with respect to potential portfolio company investments. *See supra* discussion in Section II.A.1.a.

563 Rule 203(l)-1(a)(3).

564 Oak Investments Letter; SVB Letter.

between funding rounds.[565] In addition, a portfolio company can obtain financing for working capital or expansion needs from typical lenders, effect shareholder buyouts and conclude a simultaneous debt and equity offering, without affecting the adviser's eligibility for the venture capital exemption. For the foregoing reasons, commenters maintained, and we agree, that this approach would facilitate compliance with the rule without restricting a portfolio company's access to financing or other capital.[566] We believe that this provision of the final rule will benefit venture capital funds and their investors because it restricts a portfolio company's ability to incur debt that may implicate Congressional concerns regarding the use of leverage and effectively distinguishes advisers to venture capital funds from advisers to leveraged buyout private equity funds for which Congress did not provide an exemption.[567]

Our final rule clarifies that an adviser seeking to rely on the venture capital exemption may treat as a private fund any non-U.S. fund managed by the adviser that does not offer its securities in the United States or to U.S. persons.[568] This treatment will enable an adviser to rely on the exemption when it manages only funds that satisfy the venture capital fund definition, regardless of the funds' jurisdiction of formation and investor base. We believe that this treatment facilitates capital formation and competition because it would allow an adviser to sponsor and advise funds in different jurisdictions in order to meet the different tax or regulatory needs of the fund's investors without risking the availability of the exemption.

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565 *See, e.g., supra* note 181 and accompanying and following text.

566 *See, e.g.*, NVCA Letter; SVB Letter.

567 As discussed above, we have imposed this limitation on qualifying portfolio companies because of the focus on leverage in the Dodd-Frank Act as a potential contributor to systemic risk as discussed by the Senate Committee Report, and the testimony before Congress that stressed the lack of leverage in venture capital investing. *See supra* notes 174 and 175.

568 *See* note accompanying rule 203(l)-1.

The final rule includes several other characteristics that provide additional flexibility to venture capital advisers and their funds. For example, a qualifying fund cannot provide its investors with redemption or other liquidity rights except in extraordinary circumstances. Although venture capital funds typically do not permit investors to redeem their interests during the life of the fund,[569] the approach of the final rule allows a venture capital fund to respond to extraordinary events, including redeeming investors from the fund, without resulting in a registration obligation for the fund's adviser. Under the final rule, a venture capital fund must affirmatively represent itself as pursuing a venture capital strategy to its investors, a criterion designed to preclude advisers to certain private funds from claiming an exemption from registration for which they are not eligible. We believe that this element will allow the Commission and the investing public (particularly potential investors) to determine and confirm an adviser's rationale for remaining unregistered with the Commission.[570]

Because it takes into account existing business practices of venture capital funds and permits some flexibility for venture capital funds (and their managers) to adopt, or adapt to, new or evolving business practices, we believe that the final rule will facilitate advisers' transition to the new exemption. The rule generally limits investments of a qualifying fund, but creates a basket that will allow these funds flexibility to make limited investments that may vary from typical venture capital fund investing practices. The final rule also provides an adviser flexibility and discretion to structure transactions in underlying portfolio companies to meet the business objectives of the fund without creating significant risks of the kind that Congress suggested should require registration of the fund's adviser. We expect that this flexibility will benefit

569 *See supra* notes 255-256 and accompanying text.

570 *See* Merkl Letter (stating that a description of the investment strategy is a key element of any private placement memorandum).

investment advisers that seek to rely on the venture capital exemption because they will be able more easily to structure and operate funds that meet the definition now and in the future, but will not permit reliance on the exemption by private fund advisers that Congress did not intend to exclude from registration.

Our final rule also should benefit advisers of existing venture capital funds that fail to meet the definition of venture capital fund. Our grandfathering provision permits an adviser to rely on the exemption provided that each fund that does not satisfy the definition (i) has represented to investors that it pursues a venture capital strategy, (ii) has initially sold interests by December 31, 2010, and (iii) does not sell any additional interests after July 21, 2011.[571] We expect that most advisers to existing venture capital funds that currently rely on the private adviser exemption would be exempt from registration in reliance on the grandfathering provision.[572] As a result of this provision, we expect that advisers to existing venture capital funds that do not meet our definition will benefit because they can continue to manage existing funds without having to (i) weigh the relative costs and benefits of registration and modification of fund operations to conform existing funds with our definition and (ii) incur the costs associated with registration with the Commission or modification of existing funds. Advisers to venture capital funds that were launched by December 31, 2010 and meet the July 21, 2011 deadline for sales of all securities also would benefit from the grandfathering provision because they would not have to incur these costs. We believe that the grandfathering provision will

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[571] Rule 203(l)-1(b).

[572] A number of commenters specifically inquired about the scope of the holding out criterion and noted that under existing business practice venture capital funds may refer to themselves as private equity funds. As we discuss in greater detail above, we do not believe that the name used by a fund is the sole dispositive factor, and that satisfying the holding out criterion will depend on all of the facts and circumstances. *See supra* Section II.A.7. This criterion is similar to our general approach to antifraud provisions under the federal securities laws and our rules.

promote efficiency because it will allow advisers to existing venture capital funds to continue to rely on the exemption without having to restructure funds that may not meet the definition.[573] It also will allow advisers to funds that were launched by December 31, 2010 and can meet the other requirements of the grandfathering provision to rely on the exemption without the potential costs of having to renegotiate with potential investors and restructure those funds within the limited period before the rule is effective. After the effective date, advisers that seek to form new funds will have sufficient time and notice to structure those funds to meet the definition should they seek to rely on the exemption in section 203(l) of the Advisers Act.

Finally, we believe that our definition would include an additional benefit for investors and regulators. Section 203(l) of the Advisers Act provides an exemption specifically for advisers that "solely" advise venture capital funds. Currently none of our rules requires that an adviser exempt from registration specify the basis for the exemption. We are adopting, however, rules that would require exempt reporting advisers to identify the exemption(s) on which they are relying.[574] Requiring that venture capital funds represent themselves as such to investors should allow the Commission and the investing public (particularly potential investors in venture capital funds) to determine, and confirm, an adviser's rationale for remaining unregistered with the Commission. This element is designed to deter advisers to private funds other than venture capital funds from claiming to rely on an exemption from registration for which they are not eligible.

We believe that existing venture capital funds would meet most, if not all, of the elements of the final definition of venture capital fund. Nevertheless, we recognize that some advisers to

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573 Many commenters supported the grandfathering provision, and one specifically cited the benefit of avoiding the need to alter fund terms to the potential detriment of fund investors. AV Letter.

574 *See* Implementing Adopting Release, *supra* note 32, at n.175 and accompanying text.

existing venture capital funds that seek to rely on the exemption in section 203(l) of the Advisers Act might have to structure new funds differently to satisfy the definitional criteria under the final rule. To the extent that advisers choose not to change how they structure or manage new funds they launch, those advisers would have to register with the Commission,[575] which offers many benefits to the investing public and facilitates our mandate to protect investors. Registered investment advisers are subject to periodic examinations by our staff and are also subject to our rules including rules on recordkeeping, custody of client funds and compliance programs. We believe that in general Congress considered registration to be beneficial to investors because of, among other things, the added protections offered by registration. Accordingly, Congress limited the section 203(l) exemption to advisers solely to venture capital funds.

As noted above, we proposed, and are retaining in the final rule, certain elements in the portfolio company definition because of the focus on leverage in the Dodd-Frank Act as a potential contributor to systemic risk as discussed by the Senate Committee report,[576] and the testimony before Congress that stressed the lack of leverage in venture capital investing.[577] We expect that distinguishing between venture capital funds and other private funds that pursue investment strategies involving financial leverage that Congress highlighted for concern would benefit financial regulators mandated by the Dodd-Frank Act (such as the Financial Stability Oversight Council) with monitoring and assessing potential systemic risks. Because advisers that manage funds with these characteristics would be required to register, we expect that financial regulators could more easily obtain information and data regarding these financial

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575 *See infra* text following notes 585, 597-600 and accompanying text for a discussion of potential costs for advisers that would have to choose between registering or restructuring venture capital funds formed in the future.

576 *See supra* note 174.

577 *See supra* note 175.

market participants, which should benefit those regulators to the extent it helps to reduce the overall cost of systemic risk monitoring and assessment.[578] We believe that investors will benefit from enhanced disclosure and oversight of the activities of private fund advisers by regulators, which in turn could contribute to a more efficient allocation of capital.

2. Costs

Costs for advisers to existing venture capital funds. As we discussed in the Proposing Release and above, we do not expect that the definition of venture capital fund would result in significant costs for unregistered advisers to venture capital funds currently in existence and operating.[579] We estimate that currently there are 791 advisers to venture capital funds.[580] We expect that all these advisers, which we assume currently are not registered in reliance on the private adviser exemption, would continue to be exempt after the repeal of that exemption on July 21, 2011 in reliance on the grandfathering provision.[581] We anticipate that such advisers to

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578 *See* S. Rep. No. 111-176, *supra* note 6, at 39 (explaining the requirement that private funds disclose information regarding their investment positions and strategies, including information on fund size, use of leverage, counterparty credit risk exposure, trading and investment positions and any other information that the Commission in consultation with the Financial Stability Oversight Council determines is necessary and appropriate to protect investors or assess systemic risk).

579 Proposing Release, *supra* note 26, at text immediately preceding text accompanying n.273.

580 *See* NVCA Yearbook 2011, *supra* note 152, at Fig. 1.04 (providing the number of "active" venture capital advisers, as of December 2010, that have raised a venture capital fund within the past eight years; 456 of the total number of venture capital advisers manage less than $100 million in capital).

581 We estimate that these advisers (and any other adviser that seeks to remain unregistered in reliance on the exemption under section 203(l) of the Advisers Act or rule 203(m)-1 thereunder) would incur, on average, $2,311 per year to complete and update related reports on Form ADV, including Schedule D information relating to private funds. *See* Implementing Adopting Release, *supra* note 32, at section V.B.2. This estimate includes internal costs to the adviser of $2,032 to prepare and submit an initial report on Form ADV and $279 to prepare and submit annual amendments to the report. These estimates are based on the following calculations: $2,032 = ($4,064,000 aggregate costs ÷ 2000 advisers); $279 = ($558,800 aggregate costs ÷ 2,000 advisers). *Id.* at nn.579-581 and accompanying text. We estimate that approximately two exempt reporting advisers would file Form ADV-H annually at a cost of $189 per filing. *Id.*, at n.596 and accompanying text. We further estimate that three exempt reporting advisers would file Form

grandfathered funds will incur minimal costs, if any, to confirm that existing venture capital funds managed by the adviser meet the conditions of the grandfathering provision. We estimate that these costs would be no more than $800 to hire outside counsel to assist in this determination.[582]

We recognize, however, that advisers to funds that were launched by December 31, 2010 but have not concluded offerings to investors may incur costs to determine whether they qualify for the grandfathering provision. For example, these advisers may need to assess the impact on the fund of selling interests to initial third-party investors by December 31, 2010 and selling interests to all investors no later than July 21, 2011.[583] We do not expect that the cost of evaluating the grandfathering provision would be significant, however, because we believe that most funds in formation represent themselves as funds that pursue a venture capital strategy to their potential investors[584] and the typical fundraising period for a venture capital fund is approximately 12 months.[585] Thus, we do not anticipate that venture capital fund advisers would

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ADV-NR per year at a cost of $188 per year. *Id.*, at nn.598-602 and accompanying text. We anticipate that filing fees for exempt reporting advisers would be the same as those for registered investment advisers. *See infra* note 598. These estimates, some of which differ from the estimates included in the Proposing Release, *supra* note 26, are discussed in more detail in the Implementing Adopting Release, *supra* note 32, at section V.B.2.

[582] As discussed in the Proposing Release, we expect that a venture capital adviser would need no more than 2 hours of legal advice to learn the differences between its current business practices and the conditions for reliance on the proposed grandfathering provision. We estimate that this advice would cost $400 per hour per firm based on our understanding of the rates typically charged by outside consulting or law firms. *See* Proposing Release, *supra* note 26, at n.293. We did not receive any comments on these cost estimates.

[583] We did not receive any comments on the dates specified in the grandfathering provision. *See also supra* note 307.

[584] *See supra* note 572.

[585] *See* Breslow & Schwartz, *supra* note 241, at 2-22 ("Once the first closing [of a private equity fund] has occurred, subsequent closings are typically held over a defined period of time [the marketing period] of approximately six to twelve months."). *See also* Dow Jones Report, *supra* note 242, at 22.

have to alter typical business practices to structure or raise capital for venture capital funds being formed. Nevertheless, we recognize that after the final rule goes into effect, exempt advisers of such funds in formation may forgo the opportunity to accept investments from investors that may seek to invest after July 21, 2011 in order to comply with the grandfathering provision.

To the extent that an existing adviser could not rely on the grandfathering provision with respect to funds in formation, we also expect that the adviser would not be required to modify its business practices significantly in order to rely on the exemption. Our final rule includes many modifications requested by commenters, such as the non-qualifying basket, and as a result, we expect that these modifications would reduce some of the costs associated with modifying current business practices to satisfy the proposed definitional criteria that commenters addressed.[586] As we discuss above, we believe that the final rule better reflects venture capital activity conducted by venture capital advisers that are likely to seek to rely on the exemption, and provides flexibility that will allow these funds to take advantage of new investment opportunities. To the extent that some commenters expressed concerns that they would have to divert personnel time from other functions to monitoring inadvertent failures to meet the definitional elements, we believe that the greater investment flexibility provided by the rule would offset most of these compliance costs.

Our rule does not provide separate definitional criteria for non-U.S. advisers seeking to rely on the exemption. These advisers might incur costs to the extent that cash management instruments they typically acquire may not be “short-term holdings” for purposes of the

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586 *See, e.g.*, Charles River Letter; Gunderson Dettmer Letter; NVCA Letter (arguing that as proposed the rule would have required venture capital fund advisers to modify their business practices in order to be eligible for the exemption). *See also* ABA Letter; Davis Polk Letter; Oak Investment Letter; SVB Letter (discussing the potential costs associated with complying with various elements of the proposed rule such as managerial assistance, venture capital fund leverage and solely investing in qualifying portfolio companies).

definition.[587] We expect that these costs would be mitigated, however, to the extent that these advisers can continue to acquire these instruments using the non-qualifying basket.

Costs for new advisers and advisers to new venture capital funds. We expect that existing advisers that seek to form new venture capital funds and investment advisory firms that seek to enter the venture capital industry will incur one-time "learning costs" to determine how to structure new funds they may manage to meet the elements of our definition. We estimate that on average, there are 23 new advisers to venture capital funds each year.[588] We expect that the one-time learning costs would be no more than between $2,800 and $4,800 on average for an adviser if it hires an outside consulting or law firm to assist in determining how the elements of our definition may affect intended business practices.[589] Thus, we estimate the aggregate cost to existing advisers of determining how the definition would affect funds they plan to launch would be from $64,400 to $110,400.[590] As they launch new funds and negotiate with potential investors, these advisers would have to determine whether it is more cost effective to register or to structure the venture capital funds they manage to meet the definition. Such considerations of legal or other requirements, however, comprise a typical business and operating expense of conducting new business. New advisers that enter into the business of managing venture capital

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587 *See, e.g.*, EFAMA Letter (asserting that a non-U.S. fund could not invest in non-U.S. equivalent cash holdings under the proposed rule).

588 This is the average annual increase in the number of venture capital advisers between 1981 and 2010. *See* NVCA Yearbook 2010, *supra* note 150, at Fig. 1.04; NVCA Yearbook 2011, *supra* note 152, at Fig. 1.04.

589 We expect that a venture capital adviser would need between 7 and 12 hours of consulting or legal advice to learn the differences between its current business practices and the definition, depending on the experience of the firm and its familiarity with the elements of the rule. We estimate that this advice would cost $400 per hour per firm based on our understanding of the rates typically charged by outside consulting or law firms.

590 This estimate is based on the following calculations: 23 x $2,800 = $64,400; 23 x $4,800 = $110,400. We did not receive any comments on these cost estimates.

funds also would incur such ordinary costs of doing business in a regulated industry.[591]

In the Proposing Release, we stated that we believed that existing advisers to venture capital funds would meet most, if not all, of the elements of the proposed definition.[592] As discussed above, most commenters generally acknowledged that the proposed definition would generally encompass most venture capital investing activity that typically occurs.[593] Several noted, however, that they might deviate from typical investing patterns on occasion or wanted the flexibility to invest small amounts of capital in investments that would be precluded by the proposed definition.[594] Under the final rule, venture capital funds that qualify for the definition may invest in non-qualifying investments subject to availability of the non-qualifying basket, including investments specified by some commenters. As a result of these modifications, the final definition is more closely modeled on current business practices of venture capital funds and provides advisers with flexibility to take advantage of investment opportunities. As a result, we do not anticipate that many venture capital fund advisers would have to change significantly the structure of new funds they launch.

We also recognize that some existing venture capital funds may have characteristics that differ from the criteria in our definition. To the extent that investment advisers seek to form new venture capital funds with these characteristics, those advisers would have to choose whether to structure new venture capital funds to conform to the definition, forgo forming new funds, or register with the Commission. In any case, each investment adviser would assess the costs

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591 For estimates of the costs of registration for those advisers that would choose to register, *see infra* notes 597-600.

592 Proposing Release, *supra* note 26, at Section V.A.1.

593 *See supra* note 51.

594 *See supra* note 52.

associated with registering with the Commission relative to the costs of remaining unregistered (and hence structuring funds to meet our definition in order to be eligible for the exemption). We expect that this assessment would take into account many factors, including the size, scope and nature of an adviser's business and investor base. Such factors will vary from adviser to adviser, but each adviser would determine for itself whether registration, relative to other choices, is the most cost-effective or strategic business option.

The final rule may have effects on competition and capital formation. To the extent that advisers choose to structure new venture capital funds to conform to the definition, or choose not to form new funds in order to avoid registration, these choices could result in fewer investment choices for investors, less competition and less capital formation.[595] For example, to the extent that new venture capital funds do not invest in non-qualifying investments in excess of the 20 percent basket in order to meet the definition, the final rule could decrease competition and capital formation. If venture capital funds invest less in non-qualifying investments or more in qualifying portfolio company securities that are qualifying investments, this could increase competition among qualifying portfolio companies or private funds that invest in such companies. To the extent that funds invest more in less risky but lower yielding non-qualifying investments, this could decrease competition among investors that seek to invest in qualifying investments. To the extent that advisers choose to register in order to structure new venture capital funds without regard to the definitional criteria or in order to expand their businesses (*e.g.*, pursue additional investment strategies beyond venture capital investing or expand the potential investor base to include investors that are required to invest with registered advisers), these choices may result in greater investment choices for investors, greater competition and

[595] *See, e.g.*, Lowenstein Letter; NVCA Letter; Venrock Letter.

greater capital formation.[596]

Investment advisers to new venture capital funds that would not meet the definition would have to register and incur the costs associated with registration (assuming the adviser could not rely on the private fund adviser exemption). We note that the costs of registration for advisers that do not qualify for the venture capital fund adviser exemption flow from the Dodd-Frank Act, which removed the private adviser exemption on which they currently rely.

We estimate that the internal cost to register with the Commission would be $15,077 on average for a private fund adviser,[597] excluding the initial filing fees and annual filing fees to the Investment Adviser Registration Depository ("IARD") system operator.[598] These registration costs include the costs attributable to completing and periodically amending Form ADV, preparing brochure supplements, and delivering codes of ethics to clients.[599] In addition to the

[596] *See, e.g.*, "Asia's Cash-Poor Small Hedge Funds Vulnerable to U.S. Rules," Bloomberg.com (Feb. 23, 2011) (identifying two fund of funds managers that either require or prefer to allocate client assets to advisers registered with the Commission).

[597] This estimate is based upon the following calculations: $15,077 = ($9,627,871 aggregate costs to complete Form ADV ÷ 750 advisers expected to register with the Commission) + ($8,509,000 aggregate costs to complete private fund reporting requirements ÷ 3,800 advisers expected to provide private fund reports). *See* Implementing Adopting Release, *supra* note 32, at nn.612-618 and accompanying text for a more detailed discussion of these costs. This also assumes that the performance of this function would most likely be equally allocated between a senior compliance examiner and a compliance manager. *See id*., at n.608. Data from SIFMA's Management & Professional Earnings in the Securities Industry 2010, modified to account for an 1,800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead, suggest that costs for these positions are $235 and $273 per hour, respectively.

[598] Filing fees paid for submitting initial and annual filings through the IARD currently range from $40 to $225 based on the amount of assets an adviser has under management. The current fee schedule for registered advisers may be found on our website at http://www.sec.gov/divisions/investment/iard/iardfee.shtml. *See* Implementing Adopting Release, *supra* note 32, at n.566-567 and accompanying text (assuming for purposes of the analysis that exempt reporting advisers will pay a fee of $225 per initial or annual report).

[599] Part 1 of Form ADV requires advisers to answer basic identifying information about their business, their affiliates and their owners, information that is readily available to advisers, and thus should not result in significant costs to complete. Registered advisers must also complete Part 2 of Form ADV and file it electronically with us. Part 2 requires disclosure of certain

internal costs described above, we estimate that for an adviser choosing to use outside legal services to complete its brochure, such costs would be $5,000.[600]

New registrants would also face costs to bring their business operations into compliance with the Advisers Act and the rules thereunder. These costs, however, will vary significantly among advisers depending on the adviser's size, the scope and nature of its business, and the sophistication of its compliance infrastructure, but in any case would be an ordinary business and operating expense of entering into any business that is regulated.

We estimated in the Proposing Release that the one-time costs to new registrants to establish a compliance infrastructure would range from $10,000 to $45,000, while ongoing annual costs of compliance and examination would range from $10,000 to $50,000.[601] Some commenters suggested that these estimates are too low. Commenters identifying themselves as "middle market private equity fund" advisers estimated that they would incur one-time

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conflicts of interest and could be prepared based on information already contained in materials provided to investors, which could reduce the costs of compliance even further.

[600] *See* Implementing Adopting Release, *supra* note 32, at n.729.

[601] *See* Proposing Release, *supra* note 26, at n.303 and accompanying text. Our estimate was based on the expectation that most advisers that might choose to register for business reasons have already built compliance infrastructures as a matter of good business practice. Nevertheless, we expect advisers will incur costs for outside legal counsel to evaluate their compliance procedures initially and on an ongoing basis. We estimate that the costs to advisers to establish the required compliance infrastructure will be, on average, $20,000 in professional fees and $25,000 in internal costs including staff time. These estimates were prepared in consultation with attorneys who, as part of their private practice, have counseled private fund advisers establishing their registrations with the Commission. We included a range because we believe there are a number of unregistered advisers of private funds whose compliance operations are already substantially in compliance with the Advisers Act and that would therefore experience only minimal incremental ongoing costs as a result of registration. In connection with previous estimates we have made regarding compliance costs for registered advisers, we received comments from small advisers estimating that their annual compliance costs would be $25,000 and could be as high as $50,000. *See*, *e.g.*, Comment Letter of Joseph L. Vidich (Aug. 7, 2004). *Cf.* Comment Letter of Venkat Swarna (Sept. 14, 2004) (estimating costs of $20,000 to $25,000). These comment letters were submitted in connection with the Hedge Fund Adviser Registration Release, *supra* note 14, and are available on the Commission's Internet website at http://www.sec.gov/rules/proposed/s73004.shtml.

registration and compliance costs ranging from $50,000 to $600,000, followed by ongoing annual compliance costs ranging from $50,000 to $500,000.[602] Commenters identifying themselves as advisers to venture capital funds, however, provided much lower estimates for one-time registration and compliance costs ranging from $75,000 to $200,000, followed by ongoing annual compliance costs ranging from $50,000 to $150,000.[603]

Although some advisers may incur these costs, the costs of compliance for a new registrant can vary widely among advisers depending on their size, activities, and the sophistication of their existing compliance infrastructure. Advisers, whether registered with us or not, may have established compliance infrastructures to fulfill their fiduciary duties towards their clients under the Advisers Act. Generally, costs will likely be less for new registrants that have already established sound compliance practices and more for new registrants that have not yet established sound practices.

For example, some commenters specifically included in their cost estimates

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602 *See, e.g.,* Comment Letter of Atlas Holdings (Jan. 21, 2011) ("Atlas Letter") (estimating $500,000 in 2011 and $350,000 per year thereafter for compliance manuals and oversight, employee trading records, legal documentation, and the hiring of additional compliance employees); Comment Letter of Sentinel Capital Partners (Jan. 16, 2011) ("Sentinel Letter") (estimating between $500,000-$600,000 in 2011 and more than $375,000 per year thereafter for compliance manuals and oversight, employee trading records, legal documentation, and the hiring of additional compliance employees); Comment Letter of Charlesbank Capital Partners (Jan. 21, 2011) ("Charlesbank Letter") ("[A]lthough impossible to quantify at this point given the absence of regulations, we anticipate a substantial cost associated with ongoing compliance."); Comment Letter of Crestview Advisors, LLC (Jan. 19, 2011) ("Crestview Letter") (estimating annual costs of $300,000-$500,000); Comment Letter of Azalea Capital (Feb. 17, 2011) ("Azalea Letter") (estimating $50,000 to $100,000 per year); Comment Letter of Gen Cap America, Inc. (Jan. 21, 2011) ("Gen Cap Letter") (estimating $150,000-$250,000 per year). *See also* Memorandum to File No. S7-37-10, dated March 17, 2011, concerning a meeting with certain private fund representatives, avail. at http://www.sec.gov/comments/s7-37-10/s73710-124.pdf ("File Memorandum") (estimating that costs for small firms range from $100,000-$200,000 (exclusive of salary costs for a CCO)).

603 *See* VIA Letter (estimating an initial cost of $75,000 or more and ongoing costs of $50,000 to $150,000 per year); Pine Brook Letter (estimating initial costs of $125,000 to $200,000 and ongoing compliance costs of $100,000-150,000 per year).

compensation costs for hiring a dedicated chief compliance officer ("CCO").[604] Our compliance rule, however, does not require advisers to hire a new individual to serve as a full-time CCO, and the question of whether an adviser can look to existing staff to fulfill the CCO requirement internally is firm-specific.[605]

Although we recognize that some newly registering advisers will need to designate someone to serve as CCO on a full-time basis, we expect these will be larger advisers—those with many employees and a sizeable amount of investor assets under management. Because there is no currently-available comprehensive database of unregistered advisers, we cannot determine the number of these larger advisers in operation. These larger advisers that are not yet registered likely already have personnel who perform similar functions to a CCO, in order to address the adviser's liability exposure and protect its reputation.

In smaller advisers, the designated CCO will likely also fill another function in the adviser, and perform additional duties alongside compliance matters. Advisers designating a CCO from existing staff may experience costs that result from shifting responsibilities among staff or additional compensation, to the extent the individual is taking on additional compliance

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604 *See, e.g.*, Katten Foreign Insurance Letter ("In addition, there are added salary costs for hiring a chief compliance officer. In all, costs could be expected to total hundreds of thousands of dollars and hundreds of hours of personnel time for each new registrant."); Comment Letter of Cortec Group (Jan. 14, 2011) ("Cortec Letter") ("Furthermore, the Act requires we add a compliance officer (who has to be a senior-level executive), at a minimum annual compensation of $200,000, yet we do not engage in any activity the Act wishes to monitor."). Other commenters may have included such costs in their estimates although they did not provide details on individual components. *See, e.g.*, Crestview Letter ("As part of these new regulations, we are required to develop a compliance program; hire a compliance officer; custody our private company stock certificates, which are worthless to any party not part of the original purchase agreement; and register with the SEC.")

605 *See* Advisers Act rule 206(4)-(7) (requiring, among other things, an adviser registered or required to be registered under the Advisers Act to designate an individual (who is a supervised person) responsible for administering the policies and procedures). In determining whether existing staff can fulfill the CCO requirement, advisers may consider factors such as the size of the firm, the complexity of its compliance environment, and the qualifications of current staff.

responsibilities or giving up other non-compliance responsibilities. Costs will vary from adviser to adviser, depending on the extent to which an adviser's staff is already performing some or all of the requisite compliance functions, the extent to which the CCO's non-compliance responsibilities need to be lessened to permit allocation of more time to compliance responsibilities, and the value to the adviser of the CCO's non-compliance responsibilities.[606]

Some commenters asserted that the costs of ongoing compliance would be substantial.[607] We anticipate that there may be a number of currently unregistered advisers whose operations are already substantially in compliance with the Advisers Act and that would therefore experience only minimal incremental ongoing costs as a result of registration. There likely are other currently unregistered advisers, however, who will face additional ongoing costs to conduct their operations in compliance with the Advisers Act, and these costs may be significant for some of these advisers.

We do not have access to information that would enable us to determine these additional ongoing costs, which are predominantly internal to the advisers themselves. Incremental ongoing compliance costs will vary from adviser to adviser depending on factors such as the complexity of each adviser's activities, the business decisions it makes in structuring its response to its compliance obligations, and the extent to which it is already conducting its operations in compliance with the Advisers Act. Indeed, the broad range of estimated costs we received reflects the individualized nature of these costs and the extent to which they may vary even

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606 Although some commenters noted that requiring existing employees to assume compliance-related responsibilities would involve costs, they did not provide sufficient information on which we could estimate these costs.

607 *See supra* note 602.

among the relatively small number of commenters who provided cost estimates.[608]

Some commenters expressed concern that compliance costs would be prohibitive in comparison to their revenues or in relation to their size or activities.[609] We note, however, that an adviser is required to adopt policies and procedures that take into consideration the nature of that adviser's operations.[610] We have explained that, accordingly, we would expect smaller advisers without conflicting business interests to require much simpler policies and procedures than larger advisers that, for example, have multiple potential conflicts as a result of their other lines of business or their affiliations with other financial service firms.[611] The preparation of these simpler policies and procedures and their administration should be much less burdensome.[612]

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608 *Compare* Azalea Letter (estimated ongoing compliance costs of $50,000 to $100,000 per year) *with* Crestview Letter (estimated ongoing compliance costs of $300,000 to $500,000 per year). *See also* Charlesbank Letter (stating that costs associated with ongoing compliance are impossible to quantify at this point).

609 *See, e.g.*, Crestview Letter ("The cost of complying with these new regulations is estimated to be $300,000-$500,000 per year, which is a significant sum for a firm that invests in two to three private companies each year in relation to the benefit it provides."); Azalea Letter ("The cost of complying with these new regulations is estimated to be $50,000 to $100,000 per year, which is a significant sum for a firm that invests in two to three private companies each year."); Gen Cap Letter ("The cost of complying with these new regulations is estimated to be $150,000-$250,000 per year, which is a significant sum for a firm that invests in two to three private companies each year in relation to the benefit it provides.").

610 *See Compliance Programs of Investment Companies and Investment Advisers*, Investment Advisers Act Release No. 2204 (Dec. 17, 2003) [68 FR 74714 (Dec. 24, 2003)], discussion at section II.A.1.

611 *Id. See also id.* at n.13 (noting that even small advisers may have arrangements, such as soft dollar agreements, that create conflicts; advisers of all sizes, in designing and updating their compliance programs, must identify these arrangements and provide for the effective control of the resulting conflicts).

612 *Id.*, discussion at section II.A.1.

We also note that approximately 570 smaller advisers currently are registered with us.[613] These advisers have absorbed the compliance costs associated with registration, notwithstanding the fact that their assets under management are likely to be smaller than those of an adviser managing one venture capital fund of average size (*e.g.*, with $107.8 million in venture capital under management[614]) that may be required to register because it cannot rely on the venture capital exemption or the private fund adviser exemption. Moreover, as we explained in the Proposing Release, in connection with previous estimates we have made regarding compliance costs for registered advisers, we received comments from small advisers estimating that their annual compliance costs would be $25,000 and could be as high as $50,000.[615] Finally, as we noted in the Proposing Release, to the extent there would be an increase in registered advisers, there are benefits to registration for both investors and the Commission.[616]

We do not believe that the definition of venture capital fund is likely to affect whether advisers to venture capital funds would choose to launch new funds or whether persons would choose to enter into the business of advising venture capital funds because, as noted above, we believe the definition, as revised, reflects the way most venture capital funds currently operate. Thus, for example, we eliminated the managerial assistance criterion in the proposed definition, expanded the short-term instruments in which venture capital funds can invest and provided for a non-qualifying basket. These elements in the proposal could have resulted in costs to advisers that manage venture capital funds with business or cash management practices inconsistent with

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[613] *See* Implementing Adopting Release, *supra* note 32, at n.823 and accompanying text (noting that, based on data from the Investment Adviser Registration Depository as of April 7, 2011, 572 advisers registered with the Commission were small advisers).

[614] *See* NVCA Yearbook 2011, *supra* note 152, at 9, Fig. 1.0.

[615] *See* Proposing Release, *supra* note 26, at n.303. *See also supra* note 601.

[616] *See supra* text following note 575.

those proposed criteria and that sought to rely on the exemption.[617] As a result, we expect that the definition is not likely to significantly affect the way in which investment advisers to these funds do business and thus compete. For the same reason, we do not believe that our rule is likely to have a significant effect on overall capital formation.

Other Costs. Some commenters argued in favor of a narrow definition of venture capital fund in order to preclude advisers to other types of funds from relying on the definition.[618] One commenter expressed the concern that the definition should be narrow so that advisers generally would be subject to a consistent regulatory regime,[619] and another supported incorporating substantive Advisers Act rules, such as custody, as a condition for reliance on the various exemptions in order to protect investors.[620] To the extent that our final rule includes broader criteria and results in fewer registrants under the Advisers Act, we acknowledge that this could have an adverse impact on investors.[621]

Moreover, to the extent that our final rule includes broader criteria and results in fewer registrants, this also could reduce the amount of information available to regulators with respect to venture capital advisers relying on the exemption. Under the final rule, immediately after it acquires any non-qualifying investment (excluding short-term holdings), no more than 20 percent of a qualifying fund's capital commitments may be held in non-qualifying investments (excluding short-term holdings). As a result, initially, and possibly for a period of time during

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617 *See supra* notes 548, 586 and accompanying text.

618 *See supra* note 43.

619 CalPERS Letter. *See also* NASAA Letter (supported adding substantive requirements to the grandfathering provision).

620 CPIC Letter.

621 *See supra* text accompanying and following note 575 (discussing benefits that result from registration).

the fund's term (subject to compliance with the other elements of the rule), it may be possible for non-qualifying investments to comprise most of a qualifying fund's investment portfolio. The proposal would have required a qualifying fund to be comprised entirely of qualifying investments, which would have enabled regulators and investors to confirm with relative ease at any point in time whether a fund satisfied the definition. Modifying the definition to include a non-qualifying basket determined as a percentage of a qualifying fund's capital commitments may increase the monitoring costs that regulators and investors may incur in order to verify that a fund satisfies the definition, depending on the length of the fund's investment period and the frequency with which the fund invests in non-qualifying investments.

A number of commenters expressed concerns with certain elements of the proposed rule, which we are not modifying. Several commenters suggested that the rule specify that the leverage limit of 15 percent be calculated without regard to uncalled capital commitments because they were concerned about the potential for excessive leverage.[622] We acknowledge that a leverage limitation which includes uncalled capital commitments could result in a fund incurring, in the early stages of the fund's life, a significant degree of leverage by the fund relative to the fund's overall assets. We believe, however, that the 120-day limit would mitigate the effects of any such leverage that is incurred by a venture capital fund seeking to satisfy the definition.

Several commenters also argued that the definition of qualifying portfolio company should include certain subsidiaries that may be owned by a publicly traded company, such as research and development subsidiaries, that may seek venture capital funding.[623] As a result of

622 AFR Letter; AFL-CIO Letter.

623 BCLBE Letter; Dechert General Letter; Gunderson Dettmer Letter.

our final rule, these types of subsidiaries may have reduced access to capital investments by qualifying funds, although this cost would be mitigated by a qualifying fund's investments made through the non-qualifying basket.

Other commenters argued that the definition of venture capital fund should include funds of venture capital funds.[624] We have not modified the rule to reflect this request, because we do not believe that defining the term in this manner is consistent with the intent of Congress.[625] To the extent that an adviser to a fund of venture capital funds ceases business or ceases to offer new funds in order to avoid registration with the Commission, this could reduce the pool of potential investors investing in venture capital funds,[626] and potentially reduce capital formation for potential qualifying portfolio companies.

B. Exemption for Investment Advisers Solely to Private Funds with Less than $150 Million in Assets Under Management

As discussed in Section II.B, rule 203(m)-1 exempts from registration under the Advisers Act any investment adviser solely to private funds that has less than $150 million in assets under management in the United States. The rule implements the private fund adviser exemption, as directed by Congress, in section 203(m) of the Advisers Act and includes provisions for determining the amount of an adviser's private fund assets for purposes of the exemption and when those assets are deemed managed in the United States.[627]

1. Benefits

Method of Calculating Private Fund Assets. As discussed in Section II.B.2 above and in

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624 *See, e.g.*, Cook Children's Letter; Merkl Letter; SVB Letter.

625 *See supra* notes 204-206.

626 *See generally* Merkl Letter; SVB Letter.

627 *See supra* Sections II.B.2-3.

the Implementing Adopting Release, we are revising the instructions to Form ADV to provide a uniform method for calculating assets under management that can be used for regulatory purposes, including determining eligibility for Commission, rather than state, registration; reporting assets under management for regulatory purposes on Form ADV; and determining eligibility for the private fund adviser exemption under section 203(m) of the Advisers Act and rule 203(m)-1 thereunder and the foreign private adviser exemption under section 203(b)(3) of the Advisers Act.[628] We believe that this uniform approach will benefit regulators (both state and federal) as well as advisers, because only a single determination of assets under management is required for purposes of registration and exemption from federal registration.

The instructions to Form ADV previously permitted, but did not require, advisers to exclude certain types of managed assets.[629] As a result, it was not possible to conclude that two advisers reporting the same amount of assets under management were necessarily comparable because either adviser could have elected to exclude all or some portion of certain specified assets that it managed. We expect that specifying in rule 203(m)-1 that assets under management must be calculated according to the instructions to Form ADV will increase administrative efficiencies for advisers because they will have to calculate assets under management only once for multiple purposes.[630] In addition, we believe this will minimize costs relating to software modifications, recordkeeping, and training required to determine assets under management for regulatory purposes. We also believe that the consistent calculation and reporting of assets under

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628 *See supra* notes 332-336 and accompanying text.

629 *See* Form ADV: Instructions to Part 1A, instr. 5.b(1), as in effect before the amendments adopted in the Implementing Adopting Release, *supra* note 32.

630 *See supra* Section II.B.2. As discussed below, we are permitting advisers to calculate their private fund assets annually in connection with their annual updating amendments to their Forms ADV, rather than quarterly as proposed. Requiring annual, rather than quarterly, calculations will be less costly for advisers.

management will benefit investors and regulators because it will provide enhanced transparency and comparability of data, and allow investors and regulators to analyze on a more cost effective basis whether any particular adviser may be required to register with the Commission or is eligible for an exemption.

Many commenters generally expressed support for the implementation of a uniform method of calculating assets under management in order to maintain consistency for registration and risk assessment purposes.[631] Indeed, even some commenters who suggested that we revise aspects of the method of calculating regulatory assets under management nonetheless recognized the benefits provided by a uniform method of valuing assets for regulatory purposes.[632]

We believe that the valuation of private fund assets under rule 203(m)-1 will benefit advisers that seek to rely on the private fund adviser exemption. Under rule 203(m)-1, each adviser annually must determine the amount of its private fund assets, based on the market value of those assets, or the fair value of those assets where market value is unavailable.[633] We are

631 *See supra* note 339.

632 *See, e.g.*, AIMA Letter (suggested modifications to the method of calculating regulatory assets under management but also stated "[w]e agree that a clear and unified approach for calculation of AUM is necessary and we believe that using as a standard the assets for which an adviser has 'responsibility' is appropriate"); O'Melveny Letter (argued that the calculation of regulatory assets under management as proposed "does not provide a suitable basis to determine whether a fund adviser should be subject to the SEC's regulation" but also "agree[s] with the SEC that 'uniformity in the method for calculating assets under management would result in more consistent asset calculations and reporting across the industry and, therefore, in more coherent application of the Advisers Act's regulatory requirements and of the SEC staff's risk assessment program'").

633 *See* rule 203(m)-1(c) (requiring an adviser to calculate private fund assets annually, in accordance with General Instruction 15 to Form ADV, which together with rule 204-4 requires advisers relying on the exemption to determine their private fund assets annually, in connection with the adviser's annual updating amendments to its Form ADV). *See also* rules 203(m)-1(a)(2); 203(m)-1(b)(2); 203(m)-1(d)(1) (defining "assets under management" to mean "regulatory assets under management" in item 5.F of Form ADV, Part 1A); 203(m)-1(d)(4) (defining "private fund assets" to mean the "assets under management" attributable to a "qualifying private fund"). As

requiring advisers to fair value private fund assets so that, for purposes of the exemption, advisers value private fund assets on a meaningful and consistent basis. As we stated in the Proposing Release, we understand that many, but not all, advisers to private funds value assets based on their fair value in accordance with GAAP or other international accounting standards that require the use of fair value.[634] We acknowledged in the Proposing Release that some advisers to private funds may not use fair value methodologies, which may be more difficult to apply when the fund holds illiquid or other types of assets that are not traded on organized markets.[635]

Frequency of Calculations and the Transition Period. Rule 203(m)-1(c) specifies that an adviser relying on the exemption must calculate its private fund assets annually, in accordance with General Instruction 15 to Form ADV, rather than quarterly, as proposed. Advisers registered with us and with the states, and now advisers relying on rule 203(m)-1, must calculate their assets under management for regulatory purposes annually in connection with their annual updating amendments to Form ADV. We expect that requiring these types of advisers to calculate their assets under management for regulatory purposes on the same schedule, and using the same method, will increase efficiencies for these advisers.

The annual calculation also will allow advisers that rely on the exemption to maintain the

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discussed above, advisers are not required to fair value real estate assets in certain limited circumstances. *See supra* note 366 and accompanying text.

634 *See* Proposing Release, *supra* note 26, discussion at section V.B and n.196. *See also* ABA Letter (recommending that the Commission consider using a standard of "fair value" for valuing assets and further recommending that if assets were calculated on a net basis, private funds should be required to prepare audited annual financial statements in accordance with GAAP (or another accounting standard acceptable to the Commission), and to maintain such financial statements under section 203(m)(2)); O'Melveny Letter (agreeing with the statement in the Proposing Release that many private funds value assets based on fair value, and noting that private equity funds in particular are among the private funds that generally do not fair value).

635 *See* Proposing Release, *supra* note 26, discussion at section V.B. *See also infra* Section V.B.2.

exemption despite short-term market value fluctuations that might result in the loss of the exemption if, for example, the rule required daily valuations or, to a less significant extent, quarterly valuations as proposed.[636] Annual calculations should benefit these advisers by allowing them to avoid the cost of more frequent valuations, including costs (such as third-party quotes) associated with valuing illiquid assets, which may be particularly difficult to value because of the lack of frequency with which such assets are traded.[637] Requiring annual, rather than quarterly, calculations thus responds to concerns expressed by commenters who argued that quarterly calculations would (i) impose unnecessary costs and burdens on advisers, some of whom might not otherwise perform quarterly valuations; and (ii) inappropriately permit shorter-term fluctuations in assets under management to require advisers to register.[638]

An adviser relying on the exemption that reports private fund assets of $150 million or more in its annual updating amendment to its Form ADV will not be eligible for the exemption and must register under the Advisers Act unless it qualifies for another exemption. If the adviser

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636 *See, e.g.*, ABA Letter ("[A] semi-annual or annual measuring period would perhaps be more appropriate, and [] a longer measuring period would provide an adviser that is exempt from registration under the Private Fund Adviser Exemption assistance in avoiding issues arising from temporary increases in asset values."); AIMA Letter ("Asset valuation is a substantial administrative task and is currently undertaken annually for other purposes (for example, Form ADV), so that a requirement for annual valuation would appear to strike a fair balance between ensuring that firms whose AUM is at or above the applicable threshold are 'captured' and avoiding both complications with short-term market value fluctuations and over-burdening investment advisers.").

637 *See, e.g.*, Dechert Foreign Adviser Letter ("[T]he Foreign Asset Manager submits that a yearly calculation (rather than a quarterly calculation) would be more appropriate, as some private funds may not provide for quarterly calculations of their NAV."); Katten Foreign Advisers Letter (argued for annual calculations, noting that "[m]any advisers only determine their aggregate assets under management on an annual basis"); NASBIC/SBIA Letter ("Unless sought by the adviser, evaluations on whether to register should be made no more often than an annual basis."); Seward Letter ("We believe that annual measurement of assets for purposes of determining an adviser's ability to rely on the private fund adviser exemption would be consistent with the approach established under NSMIA.").

638 *See* AIMA Letter; Dechert Foreign Adviser Letter; Dechert General Letter; EFAMA Letter; Katten Foreign Advisers Letter; Merkl Letter; Seward Letter.

has complied with all Commission reporting requirements applicable to an exempt reporting adviser as such, however, it may apply for registration under the Advisers Act up to 90 days after filing the annual updating amendment, and may continue to act as a private fund adviser, consistent with the requirements of rule 203(m)-1, during this transition period.[639]

The transition period should benefit certain advisers. As discussed above, an adviser that has "complied with all [Commission] reporting requirements applicable to an exempt reporting adviser as such" may apply for registration with the Commission up to 90 days after filing an annual updating amendment reflecting that the adviser has private fund assets of $150 million or more, and may continue to act as a private fund adviser, consistent with the requirements of rule 203(m)-1, during this transition period.[640] In addition, by requiring annual calculations of private fund assets, we are allowing advisers to whom the transition period is available 180 days after their fiscal year-ends to register under the Advisers Act.[641] We expect that providing these advisers additional time to register will reduce the burdens associated with registration by permitting them to register in a more deliberate and cost-effective manner, as suggested by some commenters.[642]

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639 *See supra* Section II.B.2.b; rule 203(m)-1(c) (requiring advisers to calculate their private fund assets annually, in accordance with General Instruction 15 to Form ADV); General Instruction 15 to Form ADV; rule 204-4.

640 *See supra* note 378 (explaining that the transition period is available to an adviser that has complied with "all [Commission] reporting requirements applicable to an exempt reporting adviser as such," rather than "all applicable Commission reporting requirements," as proposed).

641 An adviser must file its annual Form ADV updating amendment within 90 days after the end of its fiscal year and, if the transition period is available, may apply for registration up to 90 days after filing the amendment. We proposed, in contrast, to give advisers three months to register with us after becoming ineligible to rely on the exemption due to an increase in the value of their private fund assets as reflected in the proposed quarterly calculations.

642 *See, e.g.*, Sadis & Goldberg Implementing Release Letter ("Three (3) months provides an insufficient amount of time for an investment adviser to (i) complete its ADV Parts 1, 2A and 2B, including the newly required narrative brochure and brochure supplement; (ii) submit its completed application to the Commission through IARD; and (iii) receive its approval from the

Assets under Management in the United States. Under rule 203(m)-1(a), all of the private fund assets of an adviser with a principal office and place of business in the United States are considered to be "assets under management in the United States," even if the adviser has offices outside of the United States.[643] A non-U.S. adviser must count only private fund assets it manages at a place of business in the United States toward the $150 million limit under the exemption.

As discussed below, we believe that this interpretation of "assets under management in the United States" offers greater flexibility to advisers and reduces many costs associated with compliance.[644] These costs could include difficult attribution determinations that would be required if assets are managed by teams located in multiple jurisdictions or if portfolio managers located in one jurisdiction rely heavily on research or other advisory services performed by employees located in another jurisdiction. Most commenters who addressed the issue supported the proposal to treat "assets under management in the United States" as those assets managed at a U.S. place of business.[645]

Commission, which may take up to forty-five (45) days."); Shearman Letter ("Our experience is that registering an investment adviser firm in a thoughtful and deliberate manner is often closer to a six-month task (that can sometimes take even longer depending on the need to engage new or additional service providers to the firm or its funds), so that an at least 180-day transition period would be more appropriate.").

643 As discussed above, the rule looks to an adviser's principal office and place of business as the location where it directs, controls and coordinates its advisory activities. Rule 203(m)-1(d)(3).

644 *See, e.g.*, Merkl Letter (stated that this interpretation would be easier to apply than the alternative interpretation about which we sought comment which looks to the source of the assets).

645 *See, e.g.*, Debevoise Letter ("In particular, it is our view that the discussion of the proposed definition of the term 'assets under management in the United States' is a fair reflection of the policy underlying Section 203(m) of the Advisers Act (as amended by the Dodd-Frank Act) and is consistent with prior Commission and Staff statements concerning the territorial scope of the Advisers Act."); MAp Airports Letter; Non-U.S. Adviser Letter ("By adopting a very pragmatic and sensible jurisdictional approach to regulation, the Commission is appropriately recognizing general principles of international comity and the fact that activities of non-U.S. advisers outside the United States are less likely to implicate U.S. regulatory interests."). *Cf.* Sen. Levin Letter

To the extent that this interpretation may increase the number of advisers subject to registration under the Advisers Act, we anticipate that our rule also will benefit investors by providing more information about those advisers (*e.g*., information that would become available through Form ADV, Part I). We further believe that this will enhance investor protection by increasing the number of advisers registering pursuant to the Advisers Act and by improving our ability to exercise our investor protection and enforcement mandates over those newly registered advisers. As discussed above, registration offers benefits to the investing public, including periodic examination of the adviser and compliance with rules requiring recordkeeping, custody of client funds and compliance programs.[646]

Territorial Approach. Under rule 203(m)-1(b), a non-U.S. adviser with no U.S. place of business may avail itself of the exemption even if it advises non-U.S. clients that are not private funds, provided that it does not advise any U.S. clients other than private funds.[647] We believe that this aspect of the rule, which looks primarily to the principal office and place of business of an adviser to determine eligibility for the exemption, will increase the number of non-U.S. advisers that may be eligible for the exemption. As with other Commission rules that adopt a territorial approach, the private fund adviser exemption is available to a non-U.S. adviser (regardless of its non-U.S. advisory or other business activities) in recognition that non-U.S. activities of non-U.S. advisers are less likely to implicate U.S. regulatory interests and in consideration of general principles of international comity. This aspect of the rule is designed to

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(stated that advisers managing assets in the United States of funds incorporated outside of the United States "are exactly the type of investment advisers to which the Dodd-Frank Act's registration requirements are intended to apply"). *See also supra* note 386.

646 *See supra* text preceding, accompanying, and following note 575.

647 By contrast, a U.S. adviser may "solely advise private funds" as specified in the statute. *Compare* rule 203(m)-1(a)(1) *with* rule 203(m)-1(b)(1).

encourage the participation of non-U.S. advisers in the U.S. market by applying the U.S. securities laws in a manner that does not impose U.S. regulatory and operational requirements on a non-U.S. adviser's non-U.S. advisory business.[648]

We believe that our interpretation of the availability of the private fund adviser exemption for non-U.S. advisers, as reflected in the rule, will benefit those advisers by facilitating their continued participation in the U.S. market with limited disruption to their non-U.S. advisory or other business practices.[649] This approach also should benefit U.S. investors and facilitate competition in the market for advisory services to the extent that it maintains or increases U.S. investors' access to potential advisers. Furthermore, because non-U.S. advisers that elect to avail themselves of the exemption would be subject to certain reporting requirements,[650] we believe that our approach will increase the availability of information publicly available to U.S. investors who invest in the private funds advised by such exempt but reporting non-U.S. advisers.

Most of the commenters who considered this aspect of the rule supported it, citing, among other benefits, that this interpretation would effectively protect U.S. markets and investors and is consistent with the Commission's overall territorial approach to Advisers Act regulation.[651] For example, one commenter stated that the "jurisdictional approach to only considering U.S. activities for non-U.S. advisors is prudent as it focuses on what causes

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648 *See supra* note 393 and accompanying text.

649 *See supra* Section II.B.3.

650 *See* Implementing Adopting Release, *supra* note 32, discussion at section II.B.

651 ABA Letter; Debevoise Letter; Dechert Foreign Adviser Letter; Gunderson Dettmer Letter; Katten Foreign Advisers Letter; MAp Airports Letter; Merkl Letter; Wellington Letter.

systematic [sic] risks to the U.S."[652] Another noted that non-U.S. persons dealing with non-U.S. advisers would not expect to benefit from the protections provided by the Advisers Act.[653] Another stated that this approach, together with our interpretation of "assets under management in the United States," will "avoid the issues associated with conflicting and overlapping regulation."[654]

Rule 203(m)-1(b) uses the term "United States person," which generally incorporates the definition of a "U.S. person" in Regulation S.[655] We believe that generally incorporating the definition of a "U.S. person" in Regulation S will benefit advisers, because Regulation S provides a well-developed body of law that, in our view, appropriately addresses many of the questions that will arise under rule 203(m)-1. Moreover, advisers to private funds and their counsel currently must be familiar with the definition of "U.S. person" under Regulation S in order to comply with other provisions of the federal securities laws. Commenters generally supported defining "United States person" by reference to Regulation S, confirming that the

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652 Wellington Letter.

653 Debevoise Letter. *See also* ABA Letter ("When, in the private fund context, United States investors invest with a non-United States-based investment manager, they understand they are not being afforded the investor protection safeguards of the United States Investment Advisers Act."); Avoca Letter ("It is reasonable to assume that U.S. investors who purchase shares of a private fund (as defined in section 202(a)(29)) will not expect an investment adviser that has no United States presence to be registered with the U.S. SEC as an investment adviser.").

654 ABA Letter.

655 Rule 203(m)-1(d)(8) (defining a "United States person" as any person that is a "U.S. person" as defined in Regulation S, except that any discretionary account or similar account that is held for the benefit of a United States person by a dealer or other professional fiduciary is a United States person if the dealer or professional fiduciary is a related person of the investment adviser relying on rule 203(m)-1 and is not organized, incorporated, or (if an individual) resident in the United States). As discussed above, two commenters that generally supported our incorporation of the definition in Regulation S also urged us to modify our proposed definition in certain respects. *See supra* notes 409-413 and accompanying text. We decline to accept these suggestions for the reasons discussed in Section II.B.4, and we continue to believe that advisers will benefit from the efficiencies created by our general incorporation of the definition of "U.S. person" in Regulation S.

definition is well developed and understood by advisers.[656]

We also are adding a note to rule 203(m)-1 that clarifies that a client will not be considered a United States person if the client was not a United States person at the time of becoming a client of the adviser.[657] This will benefit non-U.S. advisers, which might, absent this note, incur costs in trying to determine whether they would be permitted to rely on rule 203(m)-1 if one of their existing non-U.S. clients that is not a private fund becomes a United States person, for example if a natural person client residing abroad relocates to the United States.[658] The non-U.S. adviser could at that time be considered to have a United States person client other than a private fund.

Definition of a Qualifying Private Fund. We proposed to define a "qualifying private fund" as "any private fund that is not registered under section 8 of the Investment Company Act of 1940 (15 U.S.C 80a-8) and has not elected to be treated as a business development company pursuant to section 54 of that Act (15 U.S.C. 80a-53)."[659] We are modifying rule 203(m)-1 to also permit an adviser to treat as a "private fund," and thus as a "qualifying private fund," an issuer that qualifies for an exclusion from the definition of "investment company," as defined in section 3 of the Investment Company Act, in addition to those provided by section 3(c)(1) or

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656 AIMA Letter; CompliGlobe Letter; Debevoise Letter; Dechert General Letter; Gunderson Dettmer Letter; Katten Foreign Advisers Letter; O'Melveny Letter.

657 *See supra* Section II.B.4.

658 *See* EFAMA Letter (argued that an analogous note in the foreign private adviser exemption, revised consistent with its comments, "also should apply to the 'private fund adviser exemption' and the 'venture capital fund exemption'"); IFIC Letter ("We ask for clarification from the SEC as to whether it will apply the [analogous note to the foreign private adviser exemption] in other contexts for purposes of compliance with the U.S. federal securities laws, including compliance with Rule 12g3-2(b) of the 1934 Act.").

659 *See* proposed rule 203(m)-1(e)(5).

3(c)(7) of that Act.[660] Absent this modification, an adviser to a section 3(c)(1) or 3(c)(7) fund would lose the exemption if the fund also qualified for another exclusion.[661] For example, an adviser to a section 3(c)(1) or 3(c)(7) fund would lose the exemption if the fund also qualified for another exclusion, even though the adviser may be unaware of the fund so qualifying and the fund does not purport to rely on the other exclusion.

Expanding the range of potential "qualifying private funds," therefore, should benefit advisers to funds that also qualify for other exclusions by permitting these advisers to rely on the exemption.[662] It also will prevent advisers from violating the Advisers Act's registration requirements solely because their funds qualify for another exclusion. In addition, advisers will not be required to incur the time and expense required to assess whether the funds they advise also qualify for an additional exclusion.

2. Costs

Assets under Management in the United States. As noted above, under rule 203(m)-1, we look to an adviser's principal office and place of business as the location where the adviser directs, controls or has responsibility for the management of private fund assets, and therefore as *the* place where all the adviser's assets are managed.[663] Thus, a U.S. adviser must include all of its private fund assets under management in determining whether it exceeds the $150 million

660 Rule 203(m)-1(d)(5). An adviser relying on this provision must treat the fund as a private fund under the Advisers Act and the rules thereunder for all purposes (*e.g.*, reporting on Form ADV). *Id.*

661 A fund that qualifies for an additional exclusion would not be a private fund, because a "private fund" is a fund that would be an investment company as defined in section 3 of the Investment Company Act *but for* section 3(c)(1) or 3(c)(7) of that Act. *See supra* Section II.B.1.

662 *See, e.g.,* Dechert General Letter (argued that advisers should be permitted to treat as a private fund for purposes of rule 203(m)-1 a fund that qualifies for another exclusion from the definition of "investment company" in the Investment Company Act in addition to section 3(c)(1) or 3(c)(7), such as section 3(c)(5)(C), which excludes certain real estate funds).

663 *See supra* note 385 and accompanying text.

limit under the exemption. We also look to where day-to-day management of private fund assets may occur for purposes of a non-U.S. adviser, whose principal office and place of business is outside of the United States.[664] A non-U.S. adviser therefore would count only the private fund assets it manages at a place of business in the United States in determining the availability of the exemption. This approach is similar to the way we have identified the location of the adviser for regulatory purposes under our current rules,[665] and we believe it is the way in which most advisers would have interpreted the exemption without our rule.[666]

We believe that our approach will promote efficiency because advisers are familiar with it, and we do not anticipate that U.S. advisers to private funds would likely change their business models, the location of their private funds or the location where they manage assets as a result of the rule. As noted in the Proposing Release, we expect that non-U.S. advisers may, however, incur minimal costs to determine whether they have assets under management in the United States. We estimate that these costs would be no greater than $6,730 per adviser to hire U.S. counsel and perform an internal review to assist in this determination, in particular to assess whether a non-U.S. affiliate manages a discretionary account for the benefit of a United States

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664 *See supra* note 384 and accompanying text.

665 *See supra* note 385 and accompanying text.

666 We do not believe that the statutory text refers to where the assets themselves may be located or traded or the location of the account where the assets are held. In today's market, using the location of assets would raise numerous questions of where a security with no physical existence is "located." Although physical stock certificates were once sent to investors as proof of ownership, stock certificates are now centrally held by securities depositories, which perform electronic "book-entry" changes in their records to document ownership of securities. This arrangement reduces transmittal costs and increases efficiencies for securities settlements. *See generally* Bank for International Settlements, The Depository Trust Company: Response to the Disclosure Framework for Securities Settlement Systems (2002), http://www.bis.org/publ/cpss20r3.pdf. An account also has no physical location even if the prime broker, custodian or other service that holds assets on behalf of the customer does. Each of these approaches would be confusing and extremely difficult to apply on a consistent basis.

person under the rule.[667]

As noted above, because the rule is designed to encourage the participation of non-U.S. advisers in the U.S. market, we believe that it will have minimal regulatory and operational burdens on non-U.S. advisers and their U.S. clients. Non-U.S. advisers may rely on the rule if they manage U.S. private funds with more than $150 million in assets at a non-U.S. location as long as the private fund assets managed at a U.S. place of business are less than $150 million. This could affect competition with U.S. advisers, which must register when they have $150 million in private fund assets under management regardless of where the assets are managed.

In contrast to the many commenters who supported our approach, one commenter argued that treating U.S. and non-U.S. advisers differently would disadvantage U.S.-based advisers by permitting non-U.S. advisers to accept substantial amounts of money from U.S. investors without having to comply with certain U.S. regulatory requirements, and would cause advisers to move offshore or close U.S. offices to avoid regulation.[668]

As we explained in the Proposing Release, we believe that our interpretation recognizes

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[667] We estimated in the Proposing Release that a non-U.S. adviser would need no more than 10 hours of external legal advice (at $400 per hour) and 10 hours of internal review by a senior compliance officer (at $294 per hour) to evaluate whether the adviser would qualify for the exemption provided by rule 203(m)-1, for a total estimated cost of $6,940. We did not receive any comments on these estimates. We are, however, decreasing this estimate slightly, to $6,730, to account for more recent salary data reflecting a $273 per hour wage for senior compliance officers. *See supra* note 597. One commenter suggested that we presume for non-U.S. advisers, like U.S. advisers, that all of their private fund assets are managed at their principal office and place of business. Katten Foreign Advisers Letter. We decline to adopt this suggestion for the reasons discussed above. *See supra* notes 388-389 and accompanying text. In addition, the commenter did not convince us that the costs we estimate a non-U.S. adviser would incur in determining if it has assets under management in the United States justify foregoing our approach and its attendant benefits. To the extent the commenter suggests that we adopt an alternative interpretation to conserve our resources, we note that any interpretation that requires additional advisers to register will contribute to our workload, and registration provides benefits of its own, as discussed above.

[668] Portfolio Manager Letter. *See also* Tuttle Implementing Release Letter (argued that businesses may move offshore if they become too highly regulated in the United States).

that non-U.S. activities of non-U.S. advisers are less likely to implicate U.S. regulatory interests and is in keeping with general principles of international comity.[669] The rule also is designed to encourage the participation of non-U.S. advisers in the U.S. market by applying the U.S. securities laws in a manner that does not impose U.S. regulatory and operational requirements on a non-U.S. adviser's non-U.S. advisory business.[670] Non-U.S. advisers relying on rule 203(m)-1 will remain subject to the Advisers Act's antifraud provisions and will become subject to the requirements applicable to exempt reporting advisers. Moreover, the commenter appears to suggest that an adviser that moves offshore to avoid registering under the Advisers Act would not be subject to any regulation as an investment adviser, but we understand that most non-U.S. advisers to private funds locate in major financial centers in jurisdictions that regulate investment advisers. We therefore believe that any competitive consequences to U.S. advisers will be diminished.[671]

As we acknowledged in the Proposing Release, to avail themselves of rule 203(m)-1, some advisers might choose to move their principal offices and places of business outside of the United States and manage private funds at those locations.[672] This could result in costs to U.S. investors in private funds that are managed by these advisers because they would not have the investor protection and other benefits that result from an adviser's registration under the Advisers Act. We do not expect that many advisers would be likely to relocate for purposes of avoiding registration, however, because, as we explained in the Proposing Release, we

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[669] *See supra* note 392 and accompanying text.

[670] *See supra* note 393 and accompanying text.

[671] *See also supra* Section II.B.3. We also decline to accept a separate commenter's suggestion to permit U.S. advisers to exclude assets managed at non-U.S. offices. *See supra* notes 395-396 and accompanying and following text.

[672] *See* Proposing Release, *supra* note 26, discussion at section V.B.2.

understand that the primary reasons for advisers to locate in a particular jurisdiction involve tax and other business considerations.[673]

We also note that if an adviser did relocate, it would incur the costs of regulation under the laws of most of the foreign jurisdictions in which it may be likely to relocate, as well as the costs of complying with the reporting requirements applicable to exempt reporting advisers, unless it also qualified for the foreign private adviser exemption. We do not believe, in any case, that the adviser would relocate if relocation would result in a material decrease in the amount of assets managed because that loss would likely not justify the benefits of avoiding registration, and thus we do not believe our rule is likely to have an adverse effect on capital formation.

One commenter also proposed that we adopt an alternative approach that would look to the source of the assets.[674] Under this alternative approach, a non-U.S. adviser would count the assets of private funds attributable to U.S. investors towards the $150 million threshold, regardless of the location where it manages private funds, and a U.S. adviser would exclude assets that are not attributable to U.S. investors. As a result, more U.S. advisers might be able to rely on rule 203(m)-1 under this alternative interpretation. To the extent that non-U.S. advisers

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673 We note that the two commenters that suggested U.S. advisers might relocate to rely on the rule provided no data as to the likelihood that this would occur or the number or types of advisers who might relocate, and neither refuted our contention that the primary reasons for advisers to locate in a particular jurisdiction involve tax and other business considerations. *See* Portfolio Manager Letter; Tuttle Implementing Release Letter.

674 Portfolio Manager Letter ("If you raise significant money here you should be on the same level playing field as the fund managers located here so that we can compete fairly."). *See also* Merkl Letter (suggested that it "may be useful" to look both to assets managed from a U.S. place of business and assets contributed by U.S. private fund investors to address both investor protection and systemic risk concerns). Another commenter suggested that we determine the "assets under management in the United States" for U.S. advisers by reference to the amount of assets invested, or "in play," in the United States. Dougherty Letter. We decline to adopt this approach because it would be difficult for advisers to ascertain and monitor which assets are invested in the United States, and this approach thus would be confusing and extremely difficult to apply on a consistent basis. *See supra* note 394 and accompanying and following text.

have U.S. investors in private funds that they manage at a non-U.S. location, fewer non-U.S. advisers would be eligible for the exemption. Thus, this alternative could increase costs for those non-U.S. advisers that would have to register but reduce costs for those U.S. advisers that would not have to register.

This alternative approach also could adversely affect U.S. investors to the extent that it discouraged U.S. advisers from managing U.S. investor assets. A U.S. adviser might avoid managing assets from U.S. investors because, under this alternative interpretation, the assets would be included in determining whether the adviser was eligible to rely on rule 203(m)-1. This could reduce competition for the management of assets from U.S. investors. The likelihood of U.S. advisers seeking to avoid registration in this way might be mitigated, however, to the extent that the loss of managed assets of U.S. investors would exceed the savings from avoiding registration.

Method of Calculating Private Fund Assets. Rule 203(m)-1 incorporates the valuation methodology in the instructions to Form ADV, which requires advisers to use the market value of private fund assets, or the fair value of private fund assets where market value is unavailable, when determining regulatory assets under management and to include in the calculation certain types of assets advisers previously were permitted to exclude. The revised instructions also clarify that this calculation must be done on a gross basis.

We acknowledged in the Proposing Release that some private fund advisers may not use fair value methodologies.[675] As we explained there, the costs incurred by those advisers to use

[675] *See supra* note 634 and accompanying and following text. In addition, we estimate in the Implementing Adopting Release, based on registered advisers' responses to Items 5.D, 7.B, and 9.C of Form ADV, that approximately 3% of registered advisers have at least one private fund client that is not audited, and that these advisers therefore may incur costs to fair value their private fund assets. *See* Implementing Adopting Release, *supra* note 32, at nn.634-641 and

fair valuation methodologies would vary based on factors such as the nature of the asset, the number of positions that do not have a market value, and whether the adviser has the ability to value such assets internally or would rely on a third party for valuation services.[676] Nevertheless, we continue to believe that the requirement to use fair value would not result in significant costs for these advisers, particularly in light of our decision to require annual, rather than quarterly, valuations. We also understand that private fund advisers, including those that may not use fair value methodologies for reporting purposes, perform administrative services, including valuing assets, internally as a matter of business practice.[677]

A number of commenters objected to the requirement to determine private fund assets based on fair value, generally arguing that the requirement would cause those advisers that did not use fair value methods to incur additional costs, especially if the private funds' assets that they manage are illiquid and therefore difficult to fair value.[678] As discussed in Section II.B.2, we are sensitive to the costs this new requirement will impose, and we requested comment in the Proposing Release on our estimates concerning the costs related to fair value. Commission staff

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accompanying text. We also estimate in that release that each of these registered advisers that potentially would incur costs as a result of the fair value requirement would incur costs of $37,625 on an annual basis. *Id.*, at n.641 and accompanying text. This is the middle of the range of the estimated fair value costs, which range from $250 to $75,000 annually. *Id. See also infra* notes 680-681 and accompanying text.

676 *See* Proposing Release, *supra* note 26, at n.323 and accompanying text.

677 For example, a hedge fund adviser may value fund assets for purposes of allowing new investments in the fund or redemptions by existing investors, which may be permitted on a regular basis after an initial lock-up period. An adviser to private equity funds may obtain valuations of portfolio companies in which the fund invests in connection with financing obtained by those companies. Advisers to private funds also may value portfolio companies each time the fund makes (or considers making) a follow-on investment in the company. Private fund advisers could use these valuations as a basis for complying with the fair valuation requirement applicable to private fund assets.

678 *See, e.g.*, Gunderson Dettmer Letter; Merkl Letter; O'Melveny Letter; Seward Letter; Wellington Letter.

estimates that such an adviser would incur $1,320 in internal costs to conform its internal valuations to a fair value standard.[679] In the event a fund does not have an internal capability for valuing specific illiquid assets, we expect that it could obtain pricing or valuation services from an outside administrator or other service provider. Staff estimated that the cost of such a service would range from $1,000 to $120,000 annually, which could be borne by several funds that invest in similar assets or have similar investment strategies.[680] We did not receive any comments on these estimates. These estimates, however, assumed that an adviser would be required to calculate the fair value of its private funds assets quarterly, as required by rule 203(m)-1 as proposed. We are reducing the estimated range to $250 to $75,000 annually to reflect that rule 203(m)-1 requires advisers to calculate their private fund assets annually, rather

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679 We estimated in the Proposing Release that such an adviser would incur $1,224 in internal costs to conform its internal valuations to a fair value standard. *See* Proposing Release, *supra* note 26, at n.325. We received no comments on this estimate. We are, however, increasing this estimate slightly, to $1,320, to account for more recent salary data. This revised estimate is based upon the following calculation: 8 hours x $165/hour = $1,320. The hourly wage is based on data for a fund senior accountant from SIFMA's *Management & Professional Earnings in the Securities Industry 2010*, modified by Commission staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

680 These estimates are based on conversations with valuation service providers. We understand that the cost of valuation for illiquid fixed income securities generally ranges from $1.00 to $5.00 per security, depending on the difficulty of valuation, and is performed for clients on a weekly or monthly basis. We understand that appraisals of privately placed equity securities may cost from $3,000 to $5,000 with updates to such values at much lower prices. For purposes of this cost benefit analysis, we are estimating the range of costs for (i) a private fund that holds 50 fixed income securities at a cost of $5.00 to price and (ii) a private fund that holds privately placed securities of 15 issuers that each cost $5,000 to value initially and $1,000 thereafter. We believe that costs for funds that hold both fixed-income and privately placed equity securities would fall within the maximum of our estimated range. We note that funds that have significant positions in illiquid securities are likely to have the in-house capacity to value those securities or already subscribe to a third-party service to value them. We note that many private funds are likely to have many fewer fixed income illiquid securities in their portfolios, some or all of which may cost less than $5.00 per security to value. Finally, we note that obtaining valuation services for a small number of fixed income positions on an annual basis may result in a higher cost for each security or require a subscription to the valuation service for those that do not already purchase such services. The staff's estimate is based on the following calculations: (50 x $5.00 x 4 = $1,000); (15 x $5,000) + (15 x $1,000 x 3) = $120,000).

than quarterly as proposed.[681]

In addition, as discussed above, we have taken several steps to mitigate these costs.[682] While many advisers will calculate fair value in accordance with GAAP or another international accounting standard,[683] other advisers acting consistently and in good faith may utilize another fair valuation standard.[684] While these other standards may not provide the quality of information in financial reporting (for example, of private fund returns), we expect these calculations will provide sufficient consistency for the purposes that regulatory assets under management serve in our rules, including rule 203(m)-1.[685]

Use of the alternative approaches recommended by commenters (*e.g.*, cost basis or any method required by the private fund's governing documents other than fair value) would not meet our objective of having more meaningful and comparable valuation of private fund assets, and could result in a significant understatement of appreciated assets. Moreover, these alternative approaches could permit advisers to circumvent the Advisers Act's registration requirements. Permitting the use of any valuation standard set forth in the governing documents of the private fund other than fair value could effectively yield to the adviser the choice of the most favorable standard for determining its registration obligation as well as the application of other regulatory requirements. For these reasons and those discussed in the Implementing Adopting Release, commenters did not persuade us that the extent of the additional burdens the fair value requirement would impose on some advisers to private funds would be inappropriate in

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681 The staff's revised estimate is based on the following calculations: (50 x \$5.00 = \$250; 15 x \$5,000 = \$75,000). *See also supra* note 680.

682 *See supra* notes 363-366 and accompanying text.

683 *See supra* note 364 and accompanying text.

684 *See supra* note 365 and accompanying text.

685 *See supra* note 366 and accompanying text.

light of the value of a more meaningful and consistent calculation by all advisers to private funds.

We also do not expect that advisers' principals (or other employees) generally will cease to invest alongside the advisers' clients as a result of the inclusion of proprietary assets, as some commenters suggested.[686] If private fund investors value their advisers' co-investments as suggested by these commenters, we expect that the investors will demand them and their advisers will structure their businesses accordingly.[687]

One commenter also argued that including proprietary assets would deter non-U.S. advisers that manage large sums of proprietary assets from establishing U.S. operations and employing U.S. residents.[688] Such an adviser, however, would not be ineligible for the private fund adviser exemption merely because it established U.S. operations. As discussed in Section II.B, a non-U.S. adviser may rely on the private fund adviser exemption while also having one or more U.S. places of business, provided it complies with the exemption's conditions.

Some commenters objected to calculating regulatory assets under management on the basis of gross, rather than net, assets. They argued, among other things, that gross asset measurements would be confusing,[689] complex,[690] and inconsistent with industry practice.[691] However, nothing in the current instructions suggests that liabilities should be deducted from the calculation of an adviser's assets under management. Indeed, since 1997, the instructions have

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686 *See, e.g.*, ABA Letter; Katten Foreign Advisers Letter; Seward Letter.

687 *See supra* note 347 and accompanying text.

688 Katten Foreign Advisers Letter.

689 Dechert General Letter. *See also* Implementing Adopting Release, *supra* note 32, at n.80 and accompanying text.

690 MFA Letter.

691 *See, e.g.*, Merkl Letter; Shearman Letter. *See also supra* note 351.

stated that an adviser should not deduct securities purchased on margin when calculating its assets under management.[692] Whether a client has borrowed to purchase a portion of the assets managed does not seem to us a relevant consideration in determining the amount an adviser has to manage, the scope of the adviser's business, or the availability of the exemptions.[693]

Moreover, we are concerned that the use of net assets could permit advisers to highly leveraged funds to avoid registration under the Advisers Act even though the activities of such advisers may be significant and the funds they advise may be appropriate for systemic risk reporting.[694] One commenter argued, in contrast, that it would be "extremely unlikely that a net asset limit of $150,000,000 in private funds could be leveraged into total investments that would pose any systemic risk."[695] But a comprehensive view of systemic risk requires information about certain funds that may not present systemic risk concerns when viewed in isolation, but nonetheless are relevant to an assessment of systemic risk across the economy. Moreover, because private funds are not subject to the leverage restrictions in section 18 of the Investment Company Act, a private fund with less than $150 million in net assets could hold assets far in excess of that amount as a result of its extensive use of leverage. In addition, under a net assets test such a fund would be treated similarly for regulatory purposes as a fundamentally different fund, such as one that did not make extensive use of leverage and had $140 million in net assets.

The use of gross assets also need not cause any investor confusion, as some commenters

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692 *See* Form ADV: Instructions for Part 1A, instr. 5.b.(2), as in effect before it was amended by the Implementing Adopting Release ("Do not deduct securities purchased on margin."). Instruction 5.b.(2), as amended in the Implementing Adopting Release, provides "Do not deduct any outstanding indebtedness or other accrued but unpaid liabilities." *See* Implementing Adopting Release, *supra* note 32, discussion at section II.A.3.

693 *See id.*

694 *See id.*, at n.82 and preceding and accompanying text.

695 ABA Letter.

suggested.[696] Although an adviser will be required to use gross (rather than net) assets for purposes of determining whether it is eligible for the private fund adviser or the foreign private adviser exemptions (among other purposes), we would not preclude an adviser from holding itself out to its clients as managing a net amount of assets as may be its custom.[697]

Definition of a Qualifying Private Fund. As discussed above, we modified the definition of a "qualifying private fund" to include an issuer that qualifies for an exclusion from the definition of "investment company," as defined in section 3 of the Investment Company Act, in addition to those provided by section 3(c)(1) or 3(c)(7) of that Act. To the extent advisers are able to rely on the exemption as a result of this modification, investors and the Commission will lose the benefits registration would provide. This modification does, however, benefit advisers, as discussed above, and investors (and the Commission) will still have access to the information these advisers will be required to file as exempt reporting advisers.

Solely Advises Private Funds. Some commenters asserted, in effect, that advisers should be permitted to combine other exemptions with rule 203(m)-1 so that, for example, an adviser could advise venture capital funds with assets under management in excess of $150 million in addition to other, non-venture capital private funds with less than $150 million in assets under management.[698] One commenter argued that, by declining to adopt this view, we are imposing unnecessary burdens, particularly on advisers who advise both small private funds and small business investment companies.[699] But as we discuss in Section II.B.1, the approach the

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[696] *See, e.g.*, Dechert General Letter. *See also* Implementing Adopting Release, *supra* note 32, at n.80 and accompanying text.

[697] *See supra* note 357.

[698] NASBIC/SBIA Letter; Seward Letter.

[699] NASBIC/SBIA Letter.

commenter suggests runs contrary to the language of section 203(m), which directs us to provide an exemption "to any investment adviser of private funds, if each of such investment adviser acts solely as an adviser to private funds and has assets under management in the United States of less than $150,000,000." Thus, we believe that the costs to advisers that may have to register because they do not advise solely private funds with assets under management in the United States of less than $150 million flow directly from the Dodd-Frank Act.

Assessing Whether the Exemption is Available and Costs of Registration and Compliance. We estimate each adviser may incur between $800 to $4,800 in legal advice to learn whether it may rely on the exemption.[700] We did not receive any comments concerning these estimates. We also estimate that each adviser that registers would incur registration costs, which we estimate would be $15,077,[701] initial compliance costs ranging from $10,000 to $45,000, and ongoing annual compliance costs ranging from $10,000 to $50,000.[702] Some commenters suggested that these estimates are too low, and estimated that they would incur one-time registration and compliance costs ranging from $50,000 to $600,000, followed by ongoing annual compliance costs ranging from $50,000 to $500,000.[703] Although some advisers may incur these costs, we do not believe they are representative, as discussed above.[704] Moreover, as discussed above, commenters identifying themselves as "middle market private equity fund" advisers provided the highest estimated costs, but these commenters generally would not qualify

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700 We estimate that a private fund adviser would obtain between 2 and 12 hours of external legal advice (at a cost of $400 per hour) to determine whether it would be eligible for the private fund adviser exemption.

701 *See supra* note 597 and accompanying text.

702 *See supra* note 601 and accompanying text.

703 *See supra* notes 602-603 and accompanying text.

704 *See supra* Section V.A.2.

for the private fund adviser exemption we are required to provide under section 203(m).[705] We also note that the costs of registration for advisers that do not qualify for the private fund adviser exemption flow from the Dodd-Frank Act, which removed the private adviser exemption on which they currently rely.

C. Foreign Private Adviser Exemption

Section 403 of the Dodd-Frank Act replaces the current private adviser exemption from registration under the Advisers Act with a new exemption for any "foreign private adviser," as defined in new section 202(a)(30) of the Advisers Act.[706] We are adopting, substantially as proposed, new rule 202(a)(30)-1, which defines certain terms in section 202(a)(30) for use by advisers seeking to avail themselves of the foreign private adviser exemption, including: (i) "investor;" (ii) "in the United States;" (iii) "place of business;" and (iv) "assets under management."[707] We are also including in rule 202(a)(30)-1 the safe harbor and many of the client counting rules that appeared in rule 203(b)(3)-1.[708]

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[705] We note that the advisers that gave us these estimates for registration costs have assets under management in excess of the $150 million threshold and they are not representative of advisers that would qualify for the private fund adviser exemption. *See supra* notes 602-603 and accompanying text. We also note that approximately 570 smaller advisers currently are registered with us. *See supra* note 613 and accompanying text. These advisers have absorbed the compliance costs associated with registration, notwithstanding the fact that their revenues are likely to be smaller than those of a typical adviser that will be required to register as a result of Congress's repeal of the private adviser exemption (*e.g.*, an adviser to private funds with $150 million or more of assets under management in the United States, or a "middle market" private equity adviser). *See, e.g.*, Atlas Letter (middle market private equity adviser with $365 million of assets under management); Cortec Letter (middle market private equity adviser with less than $750 million of assets under management). *See also supra* note 614 and accompanying text.

[706] *See supra* notes 415-418 and accompanying text. The new exemption is codified as amended section 203(b)(3). *See supra* Section II.C.

[707] Rule 202(a)(30)-1(c).

[708] *See supra* Section II.C. Rule 203(b)(3)-1, which we are rescinding with the Implementing Adopting Release, provides a safe harbor for determining who may be deemed a single client for purposes of the private adviser exemption. We are not, however, carrying over rules 203(b)(3)-1(b)(4), (5), or (7). *See supra* notes 316, 420 and 425 and accompanying text.

Rule 202(a)(30)-1 clarifies several provisions used in the statutory definition of "foreign private adviser." First, the rule includes a safe harbor for counting clients, which previously appeared in rule 203(b)(3)-1, and which we have modified to account for its use in the foreign private adviser context. Under the safe harbor, an adviser would count certain natural persons as a single client under certain circumstances.[709] Rule 202(a)(30)-1 also includes another provision of rule 203(b)(3)-1 that permits an adviser to treat as a single "client" an entity that receives investment advice based on the entity's investment objectives and two or more entities that have identical owners.[710] As proposed, we are omitting the "special rule" that allowed advisers not to count as a client any person for whom the adviser provides investment advisory services without compensation.[711] Finally, the rule includes two provisions that clarify that advisers need not double-count private funds and their investors under certain circumstances.[712]

Second, section 202(a)(30) provides that a "foreign private adviser" eligible for the new registration exemption cannot have more than 14 clients "or investors in the United States." We

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709 Rule 202(a)(30)-1(a)(1).

710 Rule 202(a)(30)-1(a)(2)(i)-(ii). In addition, rule 202(a)(30)-1(b)(1) through (3) contain the following related "special rules:" (1) an adviser must count a shareholder, partner, limited partner, member, or beneficiary (each, an "owner") of a corporation, general partnership, limited partnership, limited liability company, trust, or other legal organization, as a client if the adviser provides investment advisory services to the owner separate and apart from the investment advisory services provided to the legal organization; (2) an adviser is not required to count an owner as a client solely because the adviser, on behalf of the legal organization, offers, promotes, or sells interests in the legal organization to the owner, or reports periodically to the owners as a group solely with respect to the performance of or plans for the legal organization's assets or similar matters; and (3) any general partner, managing member or other person acting as an investment adviser to a limited partnership or limited liability company must treat the partnership or limited liability company as a client.

711 *See* rule 203(b)(3)-1(b)(4); *supra* notes 425-427 and accompanying text.

712 *See* rule 202(a)(30)-1(b)(4) (an adviser is not required to count a private fund as a client if it counts any investor, as defined in the rule, in that private fund as an investor in the United States in that private fund); rule 202(a)(30)-1(b)(5) (an adviser is not required to count a person as an investor if the adviser counts such person as a client in the United States). *See also supra* note 429.

are defining "investor" in a private fund in rule 202(a)(30)-1 as any person who would be included in determining the number of beneficial owners of the outstanding securities of a private fund under section 3(c)(1) of the Investment Company Act, or whether the outstanding securities of a private fund are owned exclusively by qualified purchasers under section 3(c)(7) of that Act.[713] We are also treating as investors beneficial owners of "short-term paper" issued by the private fund, who must be qualified purchasers under section 3(c)(7) but are not counted as beneficial owners for purposes of section 3(c)(1).[714]

Third, rule 202(a)(30)-1 defines "in the United States" generally by incorporating the definition of a "U.S. person" and "United States" under Regulation S.[715] In particular, we define "in the United States" in rule 202(a)(30)-1 to mean: (i) with respect to any place of business, any such place located in the "United States," as defined in Regulation S;[716] (ii) with respect to any client or private fund investor in the United States, any person who is a "U.S. person" as defined in Regulation S,[717] except that under the rule, any discretionary account or similar account that is held for the benefit of a person "in the United States" by a non-U.S. dealer or other professional fiduciary is a person "in the United States" if the dealer or professional fiduciary is a related person of the investment adviser relying on the exemption; and (iii) with respect to the public, in

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713 *See* rule 202(a)(30)-1(c)(2); *supra* Section II.C.2. In order to avoid double-counting, the rule allows an adviser to treat as a single investor any person who is an investor in two or more private funds advised by the adviser. *See* rule 202(a)(30)-1, at note to paragraph (c)(2).

714 *See* rule 202(a)(30)-1(c)(2)(ii); *supra* notes 453-462 and accompanying text. Consistently with section 3(c)(1) and section (3)(c)(7) of the Investment Company Act, the final rule, unlike the proposed rule, does not treat knowledgeable employees as "investors." *Cf.* proposed rule 202(a)(30)-1(c)(1)(i).

715 Rule 202(a)(30)-1(c)(3). *See supra* Section II.C.3.

716 *See* 17 CFR 230.902(l).

717 *See* 17 CFR 230.902(k). We are allowing foreign advisers to determine whether a client or investor is "in the United States" by reference to the time the person became a client or acquires securities issued by the private fund. *See* rule 202(a)(30)-1, at note to paragraph (c)(3)(i).

the "United States," as defined in Regulation S.[718]

Fourth, rule 202(a)(30)-1 defines "place of business" to have the same meaning as in Advisers Act rule 222-1(a).[719] Finally, for purposes of rule 202(a)(30)-1, we are defining "assets under management" by reference to "regulatory assets under management" as determined under Item 5 of Form ADV.[720]

1. Benefits

We are defining certain terms included in the statutory definition of "foreign private adviser" in order to clarify the meaning of these terms and reduce the potential administrative and regulatory burdens for advisers that seek to rely on the foreign private adviser exemption. As noted above, our rule references definitions set forth in other Commission rules under the Advisers Act, the Investment Company Act and the Securities Act, all of which are likely to be familiar to non-U.S. advisers active in the U.S. capital markets.

As we discussed in the Proposing Release, we anticipate that by defining these terms we will benefit non-U.S. advisers by providing clarity with respect to the terms that advisers would otherwise be required to interpret (and which they would likely interpret with reference to the rules we reference).[721] Our approach provides consistency among these other rules and the new exemption. This should limit non-U.S. advisers' need to undertake additional analysis with

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718 *See* 17 CFR 230.902(l).

719 *See* rule 202(a)(30)-1(c)(4); rule 222-1(a) (defining "place of business" of an investment adviser as: "(1) An office at which the investment adviser regularly provides investment advisory services, solicits, meets with, or otherwise communicates with clients; and (2) Any other location that is held out to the general public as a location at which the investment adviser provides investment advisory services, solicits, meets with, or otherwise communicates with clients."). *See supra* Section II.C.4.

720 Rule 202(a)(30)-1(c)(1); Form ADV: Instructions to Part 1A, instr. 5.b(4). *See also supra* Section II.C.5.

721 *See* Proposing Release, *supra* note 26, at n.350 and accompanying text.

respect to these terms for purposes of determining the availability of the foreign private adviser exemption.[722] We believe that the consistency and clarity that results from the rule will promote efficiency for non-U.S. advisers and the Commission. Commenters that expressed support for the proposed definitions confirmed that the references to other rules will allow advisers to apply existing concepts and maintain consistency with current interpretations.[723]

For example, for purposes of determining eligibility for the foreign private adviser exemption, advisers must count clients substantially in the same manner as they counted clients under the private adviser exemption.[724] In identifying "investors," advisers can generally rely on the determination made to assess whether the private fund meets the counting or qualification requirements under section 3(c)(1) or 3(c)(7) of the Investment Company Act.[725] In determining whether a client, an investor, or a place of business is "in the United States," or whether it holds itself out as an investment adviser to the public "in the United States," an adviser generally will apply the same analysis it would otherwise apply under Regulation S.[726] In identifying whether it has a place of business in the United States, an adviser will use the definition of "place of business" as defined in Advisers Act rule 222-1, which is used to determine whether a state may

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722 This is true for all of the definitions except for "assets under management." An adviser that relies on the foreign private adviser exemption must calculate its assets under management according to the instructions to Item 5 of Form ADV only for purposes of determining the availability of the exemption. As discussed above, rule 202(a)(30)-1 includes a reference to Item 5 of Form ADV in order to provide for consistency in the calculation of assets under management for various purposes under the Advisers Act. *See supra* note 497 and accompanying text.

723 *See, e.g.*, Dechert General Letter (with respect to the definition of "investor"); Dechert Foreign Adviser Letter and IFIC Letter (noting that the proposed definition of "in the United States" has the benefit of relying on existing guidance that is generally used by investment advisers); O'Melveny Letter (with respect to the definition of "U.S. person").

724 *See supra* Section II.C.1.

725 *See supra* note 432 and accompanying text.

726 *See supra* notes 471-472 and accompanying text.

assert regulatory jurisdiction over the adviser.[727]

As noted above, the definitions of "investor" and "United States" under our rule rely on existing definitions, with slight modifications.[728] Our rule also incorporates the safe harbor that appeared in rule 203(b)(3)-1 for counting clients, except that it no longer allows an adviser to disregard clients for whom the adviser provides services without compensation.[729] We are making these modifications (collectively, the "modifications") in order to preclude some advisers from excluding certain assets or clients from their calculation so as to avoid registration with the Commission and the regulatory requirements associated with registration.[730] Without a definition of these terms, advisers would likely rely on the same definitions we reference in rule 202(a)(30)-1, but without the modifications. We expect, therefore, that the rule likely will have the practical effect of narrowing the scope of the exemption, and thus likely will result in more advisers registering than if it reflected no modifications from the current rules.

The final rule does not include one of the modifications we proposed. The final rule does not treat knowledgeable employees as investors, consistent with sections 3(c)(1) and 3(c)(7).[731] As some commenters noted, treating knowledgeable employees in the same manner for purposes of the definition of investor and sections 3(c)(1) and 3(c)(7) will simplify advisers' compliance

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727 *See supra* Section II.C.4. Under section 222 of the Advisers Act, a state may not require an adviser to register if the adviser does not have a "place of business" within, and has fewer than 6 client residents of, the state.

728 *See supra* Sections II.C.2 and II.C.3.

729 *See supra* Section II.C.1.

730 *See supra* notes 453-462 and accompanying and following text and notes 474-477 and accompanying text. *See also infra* notes 744-747 for an estimate of the costs associated with registration.

731 *See supra* notes 448-452 and accompanying text.

with these regulatory requirements.[732] In addition, as a result of this treatment of knowledgeable employees, more non-U.S. advisers will be able to rely on the exemption.

We believe that any increase in registration as compared to the number of non-U.S. advisers that might have registered if we had not adopted rule 202(a)(30)-1 will benefit investors. Investors whose assets are, directly or indirectly, managed by the non-U.S. advisers that will be required to register will benefit from the increased protection afforded by federal registration of the adviser and application to the adviser of all of the requirements of the Advisers Act. As noted above, registration offers benefits to the investing public, including periodic examination of the adviser and compliance with rules requiring recordkeeping, custody of client funds and compliance programs.[733]

2. Costs

As discussed in the Proposing Release, we do not believe our definitions will result in significant costs for non-U.S. advisers.[734] Non-U.S. advisers that seek to avail themselves of the foreign private adviser exemption will incur costs to determine whether they are eligible for the exemption. We expect that these advisers will consult with outside U.S. counsel and perform an internal review of the extent to which an advisory affiliate manages discretionary accounts owned by a U.S. person that would be counted toward the limitation on clients in the United States and investors in the United States. We estimate these costs will be $6,730 per adviser.[735]

Without the rule, we believe that most advisers would have interpreted the new statutory

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[732] *See* Seward Letter; Shearman Letter.

[733] *See supra* text accompanying and following note 575.

[734] *See* Proposing Release, *supra* note 26, at section V.C.2.

[735] *See supra* note 667 and accompanying text. As noted above, we are decreasing this estimate to $6,730 to account for more recent salary data. *Id.* We did not receive any comments on the costs we estimated advisers would incur to perform this internal review.

provision by reference to the same rules that rule 202(a)(30)-1 references. Without our rule, some advisers would have likely incurred additional costs because they would have sought guidance in interpreting the terms used in the statutory exemption. By defining the statutory terms in a rule, we believe that we are providing certainty for non-U.S. advisers and limiting the time, compliance costs and legal expenses non-U.S. advisers would have incurred in seeking an interpretation, all of which could have inhibited capital formation and reduced efficiency. Advisers will also be less likely to seek additional assistance from us because they can rely on relevant guidance that we have previously provided with respect to the definitions that rule 202(a)(30)-1 references. We also believe that non-U.S. advisers' ability to rely on the definitions that the rule references and the guidance provided with respect to the referenced rules will reduce Commission resources that would have otherwise been applied to administering the foreign private adviser exemption, which resources can be allocated to other matters.

Our instruction allowing non-U.S. advisers to determine whether a client or investor is "in the United States" by reference to the time the person became a client or an investor acquires securities issued by the private fund should also reduce advisers' costs.[736] Advisers will make the determination only once and will not be required to monitor changes in the status of each client and private fund investor. Moreover, if a client or an investor moved to the United States, the adviser would not have to choose among registering with us, terminating the relationship with the client, or forcing the investor out of the the private fund. Some commenters agreed that the instruction will benefit advisers.[737]

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736 *See* rule 202(a)(30)-1, at note to paragraph (c)(3)(i); *supra* note 476 and accompanying text.

737 *See* Dechert General Letter ("The note provides helpful relief at a time when advisory clients often move across international borders while keeping an existing relationship with a financial institution."); IFIC Letter (the proposed approach "is consistent with the current interpretations on

Some commenters disagreed with the Proposing Release's explanation of how the exemption's requirement that an adviser look through to private fund investors would apply with respect to certain structures, such as master-feeder funds and total return swaps.[738] In both respects, we note that the obligation to look through certain transactions stems from section 208(d) of the Advisers Act (section 48(a) of the Investment Company Act with respect to sections 3(c)(1) and 3(c)(7)) as it applies to an adviser's obligations to look through to private fund investors for purposes of the foreign private adviser exemption. Thus, any costs associated with the statutory provisions that prohibit any person from doing indirectly or through or by another person anything that would be unlawful to do directly flow from those provisions, rather than any definitions we are adopting.

Some commenters expressed concern that the look-through requirement contained in the statutory definition of a "foreign private adviser" could impose significant burdens on advisers to non-U.S. funds, including non-U.S. retail funds publicly offered outside of the United States.[739] Two of these commenters stated, for example, that in their view a non-U.S. fund could be considered a private fund as a result of independent actions of U.S. investors, such as if a non-U.S. shareholder of a non-U.S. fund moves to the United States and purchases additional

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which Canadian advisers have relied for many years, and will ensure continuity and certainty in their business operations.").

738 *See* Dechert General Letter; EFAMA Letter. *See also supra* notes 442-444 and accompanying text. As we discussed above, for purposes of the look-through provision, the adviser to a master fund in a master-feeder arrangement must treat as investors the holders of the securities of any feeder fund formed or operated for the purpose of investing in the master fund rather than the feeder funds, which act as conduits. In addition, an adviser must count as an investor any owner of a total return swap on the private fund because that arrangement effectively provides the risks and rewards of investing in the private fund to the swap owner.

739 *See* AFG letter; Dechert Foreign Adviser Letter; EFAMA Letter; Shearman Letter.

shares.[740] If these funds were "private funds," their advisers would, if seeking to rely on the foreign private adviser exemption, be required to determine the number of private fund investors in the United States and the assets under management attributable to them.

As we explain above, if an adviser reasonably believes that an investor is not "in the United States," the adviser may treat the investor as not being "in the United States." Moreover, we understand that non-U.S. private funds currently count or qualify their U.S. investors in order to avoid regulation under the Investment Company Act.[741] A non-U.S. adviser would need to count the same U.S. investors (except for holders of short-term paper with respect to a fund relying on section 3(c)(1)) in order to rely on the foreign private adviser exemption. In this respect, therefore, the look-through requirement of the foreign private adviser exemption will generally not impose any new burden on advisers to non-U.S. funds.

As discussed in the Proposing Release, the modifications will result in some costs for non-U.S. advisers who might change their business practices in order to rely on the exemption.[742] Some non-U.S. advisers may have to choose to register under the Advisers Act or to limit the scope of their contacts with the United States in order to rely on the statutory exemption for

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[740] Dechert Foreign Adviser Letter; EFAMA Letter. *See also supra* note 464 and accompanying text.

[741] This practice is consistent with positions our staff has taken in which the staff has stated it would not recommend enforcement action in certain circumstances. *See, e.g.*, Goodwin Procter No-Action Letter, *supra* note 294; Touche Remnant No-Action Letter, *supra* note 294. *See also* sections 7(d), 3(c)(1), and 3(c)(7) of the Investment Company Act. *See also, e.g.*, Canadian Tax-Deferred Retirement Savings Accounts Release, *supra* note 294, at n.23 ("The Commission and its staff have interpreted section 7(d) to generally prohibit a foreign fund from making a U.S. private offering if that offering would cause the securities of the fund to be beneficially owned by more than 100 U.S. residents.").

[742] *See* Proposing Release, *supra* note 26, at n.362 and accompanying and following text.

foreign private advisers (or the private fund adviser exemption).[743] As noted above, we have estimated the costs of registration to be $15,077.[744] In addition, we estimate that registered advisers would incur initial costs to establish a compliance infrastructure, which we estimate would range from $10,000 to $45,000 and ongoing annual costs of compliance and examination, which we estimate would range from $10,000 to $50,000.[745] Some commenters suggested that these estimates are too low, and estimated that they would incur one-time registration and compliance costs ranging from $50,000 to $600,000, followed by ongoing annual compliance costs ranging from $50,000 to $500,000.[746] Although some advisers may incur these costs, we do not believe they are representative, as discussed above.[747] Moreover, as discussed above, commenters identifying themselves as "middle market private equity fund" advisers provided the highest estimated costs, but these commenters generally would not qualify for the foreign private adviser exemption (*e.g.*, because these advisers generally appear to have places of business in the United States).

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743 *See, e.g.*, O'Melveny Letter (argued that because the foreign private adviser is subject to a low statutory asset threshold, it is likely "that the cost of enhanced regulatory compliance [resulting from advisers registering or filing reports required of advisers relying on rule 203(m)-1] may, as a commercial matter, have to be borne solely by U.S. investors, which would affect their net returns"; the commenter also stated that, alternatively, "many non-U.S. advisers with less significant amounts of U.S. assets invested in their funds may choose to restrict the participation by U.S. investors rather than attempt to comply with the Proposed Rules and, thereby, decrease the availability of potentially attractive investment opportunities to U.S. investors"). We note, however, that the benefits and costs associated with the elimination of the private adviser exemption are attributable to the Dodd-Frank Act, including the costs of registration incurred by advisers that previously relied on that exemption but that will have to register because they do not qualify for another exemption. In addition, the benefits and costs associated with the reporting requirements applicable to advisers relying on the private fund adviser exemption are associated with the separate rules that impose those requirements. *See* Implementing Adopting Release, *supra* note 32, at section II.B.

744 *See supra* note 597 and accompanying text.

745 *See supra* note 601 and accompanying text.

746 *See supra* notes 602-603 and accompanying text.

747 *See supra* Section V.A.2.

In any case, non-U.S. advisers will assess the costs of registering with the Commission relative to relying on the foreign private adviser or the private fund adviser exemption. This assessment will take into account many factors, which will vary from one adviser to another, to determine whether registration, relative to other options, is the most cost-effective business option for the adviser to pursue. If a non-U.S. adviser limited its activities within the United States in order to rely on the exemption, the modifications might have the effect of reducing competition in the market for advisory services or decreasing the availability of certain investment opportunities for U.S. investors. If the non-U.S. adviser chose to register, competition among registered advisers would increase. One commenter asserted that treating holders of short-term paper as investors could result in a U.S. commercial lender to a fund being treated as an investor, leading non-U.S. advisers to avoid U.S. lenders.[748] To the extent that the modification included in the definition of "investor" causes a non-U.S. adviser seeking to rely on the foreign private adviser exemption to limit U.S. investors in a private fund's short-term notes, the modification could have an adverse effect on capital formation and reduce U.S. lenders as sources of credit for non-U.S. funds. However, unless the extension of credit by a fund's broker-dealer or custodian bank results in the issuance of a security by the fund to its creditor, the creditor would not be considered an investor for purposes of the foreign private adviser exemption.[749]

As a result of the rule's reference to the method of calculating assets under management under Form ADV, non-U.S. advisers will use the valuation method provided in the instructions to Form ADV to verify compliance with the $25 million asset threshold included in the foreign

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[748] *See* Shearman Letter.

[749] *See Reves v. Ernst & Young*, 494 U.S. 56 (1990). *See also supra* note 458 and accompanying text.

private adviser exemption.[750] Among other things, these instructions require advisers to use the market value of private fund assets, or the fair value of private fund assets where market value is unavailable, when determining regulatory assets under management and to include in the calculation certain types of assets advisers previously were permitted to exclude.[751] Most commenters addressed the components of the new method of calculation in reference to the calculation of "regulatory assets under management" under Form ADV, or with respect to the calculation of private fund assets for purposes of the private fund adviser exemption.[752]

As discussed in the Proposing Release, some non-U.S. advisers to private funds may value assets based on their fair value in accordance with GAAP or other international accounting standards that require the use of fair value, while other advisers to private funds currently may not use fair value methodologies.[753] We noted above that the costs associated with fair valuation will vary based on factors such as the nature of the asset, the number of positions that do not have a market value, and whether the adviser has the ability to value such assets internally or relies on a third party for valuation services.[754] Nevertheless, we do not believe that the requirement to use fair value methodologies will result in significant costs for these advisers to

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[750] *See supra* Section II.C.5.

[751] *See supra* Section II.B.2.a.

[752] *See* Implementing Adopting Release, *supra* note 32, discussion at section II.A.3; *supra* Section II.B.2.a. Among those commenters who addressed the components specifically with respect to the foreign private adviser exemption, one noted that because of the requirement to include proprietary assets in the calculation, "managers, in order to qualify for the [exemption], will have an incentive to reduce their personal commitments to the private funds, and manage their own assets individually." *See* ABA Letter. This result, argues the commenter, will not be in the best interest of investors, who benefit from managers having "skin the game." As discussed in Section II.B.2, if private fund investors value their advisers' co-investments as suggested by the commenter, we expect that the investors will demand them and their advisers will structure their businesses accordingly.

[753] *See* Proposing Release, *supra* note 26, at n.365 and accompanying text.

[754] *See supra* note 676 and accompanying text.

these funds.[755] Commission staff estimates that such advisers will each incur $1,320 in internal costs to conform its internal valuations to a fair value standard.[756] In the event a fund does not have an internal capability for valuing illiquid assets, we expect that it will be able to obtain pricing or valuation services from an outside administrator or other service provider. Staff estimated that the annual cost of such a service will range from $1,000 to $120,000 annually, which could be borne by several funds that invest in similar assets or have similar investment strategies.[757] We did not receive any comments on these estimates.

VI. REGULATORY FLEXIBILITY CERTIFICATION

The Commission certified in the Proposing Release, pursuant to section 605(b) of the Regulatory Flexibility Act,[758] that proposed rules 203(l)-1 and 203(m)-1 under the Advisers Act would not, if adopted, have a significant economic impact on a substantial number of small entities.[759] As we explained in the Proposing Release, under Commission rules, for the purposes of the Advisers Act and the Regulatory Flexibility Act, an investment adviser generally is a small entity if it: (i) has assets under management having a total value of less than $25 million; (ii) did not have total assets of $5 million or more on the last day of its most recent fiscal year; and (iii) does not control, is not controlled by, and is not under common control with another investment adviser that has assets under management of $25 million or more, or any person (other than a natural person) that had $5 million or more on the last day of its most recent fiscal year ("small

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755 *See supra* text following note 676.

756 *See supra* note 679.

757 *See supra* note 680.

758 5 U.S.C. 605(b)

759 *See* Proposing Release, *supra* note 26, at section VI.

adviser").[760]

Investment advisers solely to venture capital funds and advisers solely to private funds in each case with assets under management of less than $25 million would remain generally ineligible for registration with the Commission under section 203A of the Advisers Act.[761] We expect that any small adviser solely to existing venture capital funds that would not be ineligible to register with the Commission would be able to avail itself of the exemption from registration under the grandfathering provision. If an adviser solely to a new venture capital fund could not avail itself of the exemption because, for example, the fund it advises did not meet the definition of "venture capital fund," we anticipate that the adviser could avail itself of the exemption in section 203(m) of the Advisers Act as implemented by rule 203(m)-1. Similarly, we expect that any small adviser solely to private funds would be able to rely on the exemption in section 203(m) of the Advisers Act as implemented by rule 203(m)-1.

Thus, we believe that small advisers solely to venture capital funds and small advisers to other private funds will generally be ineligible to register with the Commission. Those small advisers that may not be ineligible to register with the Commission, we believe, would be able to rely on the venture capital fund adviser exemption under section 203(l) of the Advisers Act or the private fund adviser exemption under section 203(m) of that Act as implemented by our rules. For these reasons, we certified in the Proposing Release that rules 203(l)-1 and 203(m)-1 under the Advisers Act would not, if adopted, have a significant economic impact on a substantial number of small entities. Although we requested written comments regarding this

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760 Rule 0-7(a) (17 CFR 275.0-7(a)).

761 Section 203A of the Advisers Act (prohibiting an investment adviser that is regulated or required to be regulated as an investment adviser in the State in which it maintains its principal office and place of business from registering with the Commission unless the adviser has $25 million or more in assets under management or is an adviser to a registered investment company).

certification, no commenters responded to this request.

VII. STATUTORY AUTHORITY

The Commission is adopting rule 202(a)(30)-1 under the authority set forth in sections 403 and 406 of the Dodd-Frank Act, to be codified at sections 203(b) and 211(a) of the Advisers Act, respectively (15 U.S.C. 80b-3(b), 80b-11(a)). The Commission is adopting rule 203(l)-1 under the authority set forth in sections 406 and 407 of the Dodd-Frank Act, to be codified at sections 211(a) and 203(l) of the Advisers Act, respectively (15 U.S.C. 80b-11(a), 80b-3(l)). The Commission is adopting rule 203(m)-1 under the authority set forth in sections 406 and 408 of the Dodd-Frank Act, to be codified at sections 211(a) and 203(m) of the Advisers Act, respectively (15 U.S.C. 80b-11(a), 80b-3(m)).

List of Subjects in 17 CFR Part 275

Reporting and recordkeeping requirements; Securities

TEXT OF RULES

For reasons set out in the preamble, the Commission amends Title 17, Chapter II of the Code of Federal Regulations as follows:

PART 275 – RULES AND REGULATIONS, INVESTMENT ADVISERS ACT OF 1940

1. The general authority citation for Part 275 is revised to read as follows:

Authority: 15 U.S.C. 80b-2(a)(11)(G), 80b-2(a)(11)(H), 80b-2(a)(17), 80b-3, 80b-4, 80b-4a, 80b-6(4), 80b-6(a), and 80b-11, unless otherwise noted.

* * * * *

2. Section 275.202(a)(30)-1 is added to read as follows:

§ 275.202(a)(30)-1 Foreign private advisers.

(a) *Client*. You may deem the following to be a single client for purposes of section 202(a)(30) of the Act (15 U.S.C. 80b-2(a)(30)):

(1) A natural person, and:

(i) Any minor child of the natural person;

(ii) Any relative, spouse, spousal equivalent, or relative of the spouse or of the spousal equivalent of the natural person who has the same principal residence;

(iii) All accounts of which the natural person and/or the persons referred to in this paragraph (a)(1) are the only primary beneficiaries; and

(iv) All trusts of which the natural person and/or the persons referred to in this paragraph (a)(1) are the only primary beneficiaries;

(2)(i) A corporation, general partnership, limited partnership, limited liability company, trust (other than a trust referred to in paragraph (a)(1)(iv) of this section), or other legal organization (any of which are referred to hereinafter as a "legal organization") to which you provide investment advice based on its investment objectives rather than the individual investment objectives of its shareholders, partners, limited partners, members, or beneficiaries (any of which are referred to hereinafter as an "owner"); and

(ii) Two or more legal organizations referred to in paragraph (a)(2)(i) of this section that have identical owners.

(b) *Special rules regarding clients*. For purposes of this section:

(1) You must count an owner as a client if you provide investment advisory services to the owner separate and apart from the investment advisory services you provide to the legal organization, provided, however, that the determination that an owner is a client will not affect the applicability of this section with regard to any other owner;

(2) You are not required to count an owner as a client solely because you, on behalf

of the legal organization, offer, promote, or sell interests in the legal organization to the owner, or report periodically to the owners as a group solely with respect to the performance of or plans for the legal organization's assets or similar matters;

(3) A limited partnership or limited liability company is a client of any general partner, managing member or other person acting as investment adviser to the partnership or limited liability company;

(4) You are not required to count a private fund as a client if you count any investor, as that term is defined in paragraph (c)(2) of this section, in that private fund as an investor in the United States in that private fund; and

(5) You are not required to count a person as an investor, as that term is defined in paragraph (c)(2) of this section, in a private fund you advise if you count such person as a client in the United States.

Note to paragraphs (a) and (b): These paragraphs are a safe harbor and are not intended to specify the exclusive method for determining who may be deemed a single client for purposes of section 202(a)(30) of the Act (15 U.S.C. 80b-2(a)(30)).

(c) *Definitions.* For purposes of section 202(a)(30) of the Act (15 U.S.C. 80b-2(a)(30)):

(1) *Assets under management* means the regulatory assets under management as determined under Item 5.F of Form ADV (§ 279.1 of this chapter).

(2) *Investor* means:

(i) Any person who would be included in determining the number of beneficial owners of the outstanding securities of a private fund under section 3(c)(1) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(c)(1)), or whether the outstanding securities of a private fund are owned exclusively by qualified purchasers under section 3(c)(7) of that Act (15 U.S.C. 80a-3(c)(7)); and

(ii) Any beneficial owner of any outstanding short-term paper, as defined in section 2(a)(38) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(38)), issued by the private fund.

Note to paragraph (c)(2): You may treat as a single investor any person who is an investor in two or more private funds you advise.

(3) *In the United States* means with respect to:

(i) Any client or investor, any person who is a U.S. person as defined in § 230.902(k) of this chapter, except that any discretionary account or similar account that is held for the benefit of a person in the United States by a dealer or other professional fiduciary is in the United States if the dealer or professional fiduciary is a related person, as defined in § 275.206(4)-2(d)(7), of the investment adviser relying on this section and is not organized, incorporated, or (if an individual) resident in the United States.

Note to paragraph (c)(3)(i): A person who is in the United States may be treated as not being in the United States if such person was not in the United States at the time of becoming a client or, in the case of an investor in a private fund, each time the investor acquires securities issued by the fund.

(ii) Any place of business, *in the United States*, as that term is defined in § 230.902(l) of this chapter; and

(iii) The public, *in the United States*, as that term is defined in § 230.902(l) of this chapter.

(4) *Place of business* has the same meaning as in § 275.222-1(a).

(5) *Spousal equivalent* has the same meaning as in § 275.202(a)(11)(G)-1(d)(9).

(d) *Holding out*. If you are relying on this section, you shall not be deemed to be holding yourself out generally to the public in the United States as an investment adviser, within the meaning of section 202(a)(30) of the Act (15 U.S.C. 80b-2(a)(30)), solely because you participate in a non-public offering in the United States of securities issued by a private fund under the Securities Act of 1933 (15 U.S.C. 77a).

3. Section 275.203(l) -1 is added to read as follows:

§ 275.203(l)-1 Venture capital fund defined.

(a) *Venture capital fund defined*. For purposes of section 203(l) of the Act (15 U.S.C. 80b-3(l)), a venture capital fund is any private fund that:

(1) Represents to investors and potential investors that it pursues a venture capital strategy;

(2) Immediately after the acquisition of any asset, other than qualifying investments or short-term holdings, holds no more than 20 percent of the amount of the fund's aggregate capital contributions and uncalled committed capital in assets (other than short-term holdings) that are not qualifying investments, valued at cost or fair value, consistently applied by the fund;

(3) Does not borrow, issue debt obligations, provide guarantees or otherwise incur leverage, in excess of 15 percent of the private fund's aggregate capital contributions and uncalled committed capital, and any such borrowing, indebtedness, guarantee or leverage is for a non-renewable term of no longer than 120 calendar days, except that any guarantee by the private fund of a qualifying portfolio company's obligations up to the amount of the value of the private fund's investment in the qualifying portfolio company is not subject to the 120 calendar day limit;

(4) Only issues securities the terms of which do not provide a holder with any right, except in extraordinary circumstances, to withdraw, redeem or require the repurchase of such securities but may entitle holders to receive distributions made to all holders pro rata; and

(5) Is not registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8), and has not elected to be treated as a business development company pursuant to section 54 of that Act (15 U.S.C. 80a-53).

(b) *Certain pre-existing venture capital funds*. For purposes of section 203(l) of the Act (15 U.S.C. 80b-3(l)) and in addition to any venture capital fund as set forth in paragraph (a) of this section, a venture capital fund also includes any private fund that:

(1) Has represented to investors and potential investors at the time of the offering of the private fund's securities that it pursues a venture capital strategy;

(2) Prior to December 31, 2010, has sold securities to one or more investors that are not related persons, as defined in § 275.206(4)-2(d)(7), of any investment adviser of the private fund; and

(3) Does not sell any securities to (including accepting any committed capital from) any person after July 21, 2011.

(c) *Definitions*. For purposes of this section:

(1) *Committed capital* means any commitment pursuant to which a person is obligated to:

(i) Acquire an interest in the private fund; or

(ii) Make capital contributions to the private fund.

(2) *Equity security* has the same meaning as in section 3(a)(11) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(11)) and § 240.3a11-1 of this chapter.

(3) *Qualifying investment* means:

(i) An equity security issued by a qualifying portfolio company that has been acquired directly by the private fund from the qualifying portfolio company;

(ii) Any equity security issued by a qualifying portfolio company in exchange for an equity security issued by the qualifying portfolio company described in paragraph (c)(3)(i) of this section; or

(iii) Any equity security issued by a company of which a qualifying portfolio company is a majority-owned subsidiary, as defined in section 2(a)(24) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(24)), or a predecessor, and is acquired by the private fund in exchange for an *equity security* described in paragraph (c)(3)(i) or (c)(3)(ii) of this section.

(4) *Qualifying portfolio company* means any company that:

(i) At the time of any investment by the private fund, is not reporting or foreign traded and does not control, is not controlled by or under common control with another company, directly or indirectly, that is reporting or foreign traded;

(ii) Does not borrow or issue debt obligations in connection with the private fund's investment in such company and distribute to the private fund the proceeds of such borrowing or issuance in exchange for the private fund's investment; and

(iii) Is not an investment company, a private fund, an issuer that would be an investment company but for the exemption provided by § 270.3a-7 of this chapter, or a commodity pool.

(5) *Reporting or foreign traded* means, with respect to a company, being subject to the reporting requirements under section 13 or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)), or having a security listed or traded on any exchange or organized market

operating in a foreign jurisdiction.

(6) *Short-term holdings* means cash and cash equivalents, as defined in § 270.2a51-1(b)(7)(i) of this chapter, U.S. Treasuries with a remaining maturity of 60 days or less, and shares of an open-end management investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8) that is regulated as a money market fund under § 270.2a-7 of this chapter.

Note: For purposes of this section, an investment adviser may treat as a private fund any issuer formed under the laws of a jurisdiction other than the United States that has not offered or sold its securities in the United States or to U.S. persons in a manner inconsistent with being a private fund, provided that the adviser treats the issuer as a private fund under the Act (15 U.S.C. 80b) and the rules thereunder for all purposes.

4. Section 275.203(m)-1 is added to read as follows:

§ 275.203(m)-1 Private fund adviser exemption.

(a) *United States investment advisers*. For purposes of section 203(m) of the Act (15 U.S.C. 80b-3(m)), an investment adviser with its principal office and place of business in the United States is exempt from the requirement to register under section 203 of the Act if the investment adviser:

(1) Acts solely as an investment adviser to one or more qualifying private funds; and

(2) Manages private fund assets of less than $150 million.

(b) *Non-United States investment advisers*. For purposes of section 203(m) of the Act (15 U.S.C. 80b-3(m)), an investment adviser with its principal office and place of business outside of the United States is exempt from the requirement to register under section 203 of the Act if:

(1) The investment adviser has no client that is a United States person except for one

or more qualifying private funds; and

(2) All assets managed by the investment adviser at a place of business in the United States are solely attributable to private fund assets, the total value of which is less than $150 million.

(c) *Frequency of Calculations*. For purposes of this section, calculate private fund assets annually, in accordance with General Instruction 15 to Form ADV (§ 279.1 of this chapter).

(d) *Definitions*. For purposes of this section:

(1) *Assets under management* means the regulatory assets under management as determined under Item 5.F of Form ADV (§ 279.1 of this chapter).

(2) *Place of business* has the same meaning as in § 275.222-1(a).

(3) *Principal office and place of business* of an investment adviser means the executive office of the investment adviser from which the officers, partners, or managers of the investment adviser direct, control, and coordinate the activities of the investment adviser.

(4) *Private fund assets* means the investment adviser's assets under management attributable to a qualifying private fund.

(5) *Qualifying private fund* means any private fund that is not registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8) and has not elected to be treated as a business development company pursuant to section 54 of that Act (15 U.S.C. 80a-53). For purposes of this section, an investment adviser may treat as a private fund an issuer that qualifies for an exclusion from the definition of an "investment company," as defined in section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a-3), in addition to those provided by section 3(c)(1) or 3(c)(7) of that Act (15 U.S.C. 80a-3(c)(1) or 15 U.S.C. 80a-3(c)(7)), provided that the

investment adviser treats the issuer as a private fund under the Act (15 U.S.C. 80b) and the rules thereunder for all purposes.

(6) *Related person* has the same meaning as in § 275.206(4)-2(d)(7).

(7) *United States* has the same meaning as in § 230.902(l) of this chapter.

(8) *United States person* means any person that is a U.S. person as defined in § 230.902(k) of this chapter, except that any discretionary account or similar account that is held for the benefit of a United States person by a dealer or other professional fiduciary is a United States person if the dealer or professional fiduciary is a related person of the investment adviser relying on this section and is not organized, incorporated, or (if an individual) resident in the United States.

Note to paragraph (d)(8): A client will not be considered a United States person if the client was not a United States person at the time of becoming a client.

By the Commission.

Elizabeth M. Murphy
Secretary

Dated: June 22, 2011

Private Fund Adviser Overview

Private funds are pooled investment vehicles that are excluded from the definition of investment company under the Investment Company Act of 1940 by section 3(c)(1) or 3(c)(7) of that Act. The term private fund generally includes funds commonly known as hedge funds and private equity funds.

Historically, many of the investment advisers to private funds had been exempt from registration with the SEC under the so-called “private adviser” exemption. The Dodd-Frank Act replaced the old “private adviser” exemption with narrower exemptions for advisers that advise exclusively venture capital funds and advisers solely to private funds with less than $150 million in assets under management in the United States. As a result of the Dodd-Frank Act, many previously unregistered advisers to private funds were required to register with the SEC or the states.

Investment advisers that are registered with the SEC have an obligation to comply with all of the applicable provisions of the Investment Advisers Act of 1940 and the related rules that have been adopted by the SEC. Click here for general information about the obligations of investment advisers that are registered with the SEC.

Investment advisers to private funds use Form ADV to register with the SEC and/or certain state securities authorities. Investment advisers to private funds must report on Form ADV general information about private funds that they manage, including basic organizational and operational information as well as information about the fund’s key service providers.

SEC-registered investment advisers with at least $150 million in private funds assets under management use Form PF to report, on a non-public basis, information about the private funds that they manage. Most advisers file Form PF annually to report general information such as the types of private funds advised (*e.g.,* hedge funds or private equity), each fund’s size, leverage, liquidity and types of investors. Certain larger advisers provide more information on a more frequent basis (including more detailed information on certain larger funds).

This page contains links to a topical reference guide for private fund advisers as well as a private fund statistics report based on aggregated data from Form PF.

Resources

- Information and Guidance
    - Topical Reference Guide — Private Fund Advisers
- Data
    - Private Funds Statistics Report
    - Form PF

Other Resources

Private Funds Statistics Report

Form PF

Modified: Oct. 21, 2016

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 275

[Release No. IA-3220; File No. S7-25-10]

RIN 3235-AK66

Family Offices

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission (the "Commission") is adopting a rule to define "family offices" that will be excluded from the definition of an investment adviser under the Investment Advisers Act of 1940 ("Advisers Act") and thus will not be subject to regulation under the Advisers Act.

EFFECTIVE DATE: [insert date 60 days after publication in the Federal Register], 2011.

FOR FURTHER INFORMATION CONTACT: Sarah ten Siethoff, Senior Special Counsel, or Vivien Liu, Senior Counsel, at (202) 551-6787 or <IArules@sec.gov>, Office of Investment Adviser Regulation, Division of Investment Management, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-8549.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission is adopting rule 202(a)(11)(G)-1 [17 CFR 275.202(a)(11)(G)-1] under the Investment Advisers Act of 1940 [15 U.S.C. 80b] (the "Advisers Act" or "Act").[1]

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[1] 15 U.S.C. 80b. Unless otherwise noted, when we refer to the Advisers Act, or any paragraph of the Advisers Act, we are referring to 15 U.S.C. 80b of the United States Code, at which the Advisers Act is codified.

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I. BACKGROUND

On October 12, 2010, the Commission issued a release proposing new rule 202(a)(11)(G)-1 that would exempt "family offices" from regulation under the Advisers Act.[2] We proposed this rule in anticipation of the Dodd-Frank Wall Street Reform and Consumer Protection Act's (the "Dodd-Frank Act")[3] repeal of the private adviser exemption from registration contained in section 203(b)(3) of the Advisers Act, effective July 21, 2011, upon which many family offices currently rely.[4]

The Dodd-Frank Act creates in its place a new exclusion from the Advisers Act in section 202(a)(11)(G) under which family offices, as defined by the Commission, are not investment advisers subject to the Advisers Act.[5] Historically, family offices that fell outside the private adviser exemption have sought and obtained from us orders under the Advisers Act declaring those offices not to be investment advisers within the intent of

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2 *See Family Offices*, Investment Advisers Act Release No. 3098 (Oct. 12, 2010) [75 FR 63753 (Oct. 18, 2010)] ("Proposing Release"). "Family offices" are entities established by wealthy families to manage their wealth and provide other services to family members. *See* section I of the Proposing Release for a discussion of family offices.

3 Pub. L. No. 111-203, 124 Stat. 1376 (2010), at section 403.

4 15 U.S.C. 80b-2(b)(3). This provision exempts from registration any adviser that during the course of the preceding 12 months had fewer than 15 clients and neither held itself out to the public as an investment adviser nor advised any registered investment company or business development company.

5 *See* section 409 of the Dodd-Frank Act.

section 202(a)(11) of the Advisers Act.[6] Recognizing this past practice, section 409 of the Dodd-Frank Act instructs that any family office definition the Commission adopts should be "consistent with the previous exemptive policy" of the Commission and recognize "the range of organizational, management, and employment structures and arrangements employed by family offices."[7]

We received approximately 90 comments on the proposed rule, most of which were submitted by law firms representing family offices.[8] Many urged that we adopt a broader exemption to accommodate typical family office structures that were not reflected in our previous exemptive orders.[9] Some urged us to include exceptions in various aspects of the rule to allow individuals or entities with no family relations to nevertheless receive investment advice from the family office without the protections of

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[6] *See, e.g.*, *Bear Creek Inc.*, Investment Advisers Act Release Nos. 1931 (Mar. 9, 2001) (notice) [66 FR 15150 (Mar. 15, 2001)] and 1935 (Apr. 4, 2001) (order); *Riverton Management, Inc.*, Investment Advisers Act Release Nos. 2459 (Dec. 9, 2005) [70 FR 74381 (Dec. 15, 2005)] and 2471 (Jan. 6, 2006) (order). We are troubled by comment letters we receive by counsel to some family offices that appear to acknowledge that their clients were operating as unregistered investment advisers, although they were not eligible for the private adviser exemption and had not obtained an exemptive order from us. We note that an adviser may not "rely" on exemptive orders issued to other persons.

[7] Section 409(b) of the Dodd-Frank Act. Section 409 also includes a "grandfathering clause" that precludes us from excluding certain family offices from the definition solely because they provide investment advice to certain clients and had provided investment advice to those clients before January 1, 2010. *See* section 409(b)(3) of the Dodd-Frank Act.

[8] The public comments we received on the Proposing Release are available on our website at http://www.sec.gov/comments/s7-25-10/s72510.shtml.

[9] *See, e.g.*, Comment Letter of the American Bar Association, Section of Business Law and Section of Real Property, Trust and Estate Law (Nov. 18, 2010) ("ABA Letter"); Comment Letter of Perkins Coie/Private Investor Coalition Inc. (Nov. 11, 2010) ("Coalition Letter"); Comment Letter of Tannenbaum, Helpern, Syracuse & Hirschtritt LLP (Nov. 18, 2010) ("Tannenbaum Letter").

the Advisers Act.[10] Some disputed our interpretation of the legislative direction we received to define the term "family office" consistent with our previous exemptive orders.[11] After careful consideration of these comment letters, we are adopting rule 202(a)(11)(G)-1, with certain modifications from our proposal as further described below.

II. DISCUSSION

We are adopting new rule 202(a)(11)(G)-1 under the Advisers Act to define the term "family office" for purposes of the Act. Family offices, as so defined, are excluded from the Act's definition of "investment adviser," and are thus not subject to any of the provisions of the Act. The scope of the rule is generally consistent with the conditions of exemptive orders that we have issued to family offices. As with the proposal, and as discussed in more detail below, our final rule in some cases has modified those conditions to turn the fact-specific exemptive orders into a rule of general applicability and to take into account the need for certain clarifications and further modifications identified by commenters.

As we discussed in the Proposing Release, our orders have provided an exclusion for family offices because we viewed them as not the sort of arrangement that the

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10 *See, e.g.*, Comment Letter of Miller & Martin PLLC (Nov. 18, 2010) ("Miller Letter") (recommending that non-family clients be permitted *de minimis* investments in family limited liability companies, partnerships, corporations and other entities and be permitted *de minimis* ownership stakes in the family office itself); Comment Letter of Porter Wright (Nov. 10, 2010) (supporting various forms of non-family client investment through the family office with five percent *de minimis* maximums for each type of exception).

11 *See, e.g.*, Coalition Letter.

Advisers Act was designed to regulate.[12] Disputes among family members concerning the operation of the family office could, as we noted in the Proposing Release, be resolved within the family unit or, if necessary, through state courts under laws designed to govern family disputes. In light of the purpose of the exclusion and the legislative instructions we received, we have not expanded the exclusion, as several commenters suggested, to permit family offices to provide advisory services to multiple families or to clients who are not family members, other than certain key employees.

The failure of a family office to be able to meet the conditions of the rule will not preclude the office from providing advisory services to family members either collectively or individually. Rather, the family office will need to register under the Advisers Act (unless another exemption is available) or seek an exemptive order from the Commission. A number of family offices currently are registered under the Advisers Act.

A. Family Office Structure and Scope of Activities

As proposed, rule 202(a)(11)(G)-1 contains three general conditions. First, the exclusion is limited to family offices that provide advice about securities only to certain "family clients." Second, it requires that family clients wholly own the family office and family members and/or family entities control the family office. Third, it precludes a family office from holding itself out to the public as an investment adviser. In addition to these conditions, we have incorporated into the rule the "grandfathering" provision required by section 409 of the Dodd-Frank Act.[13]

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12 *See* Proposing Release, *supra* note 2, at sections I and II for a discussion of the rationale for the family office exclusion.

13 *See supra* note 7 and section II.A.5 of this Release.

1. Family Clients

A family office excluded from the Act is limited to an office that advises only "family clients."[14] As discussed in more detail below, family clients include current and former family members, certain employees of the family office (and, under certain circumstances, former employees), charities funded exclusively by family clients, estates of current and former family members or key employees, trusts existing for the sole current benefit of family clients or, if both family clients and charitable and non-profit organizations are the sole current beneficiaries, trusts funded solely by family clients, revocable trusts funded solely by family clients, certain key employee trusts, and companies wholly owned exclusively by, and operated for the sole benefit of, family clients (with certain exceptions).[15]

a. *Family Member*

Under the rule, a "family member" includes all lineal descendants of a common ancestor (who may be living or deceased) as well as current and former spouses or spousal equivalents of those descendants, provided that the common ancestor is no more than 10 generations removed from the youngest generation of family members.[16] All children by adoption and current and former stepchildren also are considered family members.

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14 Rule 202(a)(11)(G)-1(b)(1).

15 The term "company" used throughout this Release and rule 202(a)(11)(G)-1 has the same meaning as in section 202(a)(5) of the Advisers Act, which defines "company" as "a corporation, a partnership, an association, a joint-stock company, a trust, or any organized group of persons, whether incorporated or not; or any receiver, trustee in a case under title 11, or similar official, or any liquidating agent for any of the foregoing, in his capacity as such."

16 Rule 202(a)(11)(G)-1(d)(6).

We have expanded persons who may be considered family members in response to several comments we received. We had proposed to define the term “family member” by reference to the “founder” of the family office, and generally to include the founder’s spouse (or spousal equivalent), their parents, their lineal descendants, and their siblings and their lineal descendants.[17] Commenters observed that the proposed rule implicitly assumed that the founder of the family office is the initial generator of the family’s wealth and is an individual or couple.[18] They noted that in many cases, however, family offices are established by persons several generations remote from the initial wealth generator.[19] Some commenters also criticized our proposed approach because it would treat who could be a family member differently depending on when the family office was established.[20] For example, one commenter stated that our proposal would have allowed a family office that was formed a long time ago to provide services to persons that are currently third or fourth cousins to each other, but that a family office established today

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17 Proposed rule 202(a)(11)(G)-1(d)(5) (defining the founders as the “natural person and his or her spouse or spousal equivalent for whose benefit the family office was established and any subsequent spouse of such individuals.” Proposed rule 202(a)(11)(G)-1(d)(3) (defining family members as “the founders, their lineal descendants (including by adoption and stepchildren), and such lineal descendants’ spouses or spousal equivalents; the parents of the founders; and the siblings of the founders and such siblings’ spouses or spousal equivalents and their lineal descendants (including by adoption and stepchildren) and such lineal descendants’ spouses or spousal equivalents”).

18 *See, e.g.*, Comment Letter of Dechert LLP (Nov. 29, 2010) (“Dechert Letter”); Comment Letter of Fried, Frank, Harris, Shriver & Jacobs LLP (Nov. 18, 2010) (“Fried Frank Letter”).

19 *See, e.g.*, Coalition Letter; Comment Letter of the New York State Bar Association, Business Law Section, Securities Regulation Committee (Dec. 10, 2010) (“NY Bar Letter”).

20 *See, e.g.*, NY Bar Letter; Comment Letter of Skadden, Arps, Slate, Meagher & Flom LLP (Nov. 17, 2010) (“Skadden Letter”).

may need to wait at least 40 or 50 years before being able to provide services to equivalent types of family members.[21]

Some commenters recommended that the Commission address these concerns by leaving the term "family member" undefined,[22] while others recommended that the Commission retain the approach of the proposed rule, but expand the rule to treat as family members grandparents, great-grandparents, aunts, uncles, great aunts, and great uncles of the founders and their spouses and children.[23] Leaving the term family member undefined could allow typical commercial investment advisory businesses to rely on the exclusion (by, for example, designating an extremely remote family member as a common ancestor). On the other hand, attempting to expand the family member definition by ascending up the family tree from the founders would not address the difficulty in identifying the founders of the family office as identified by commenters and would not address the concern, depending on when the family office was founded, that the definition will not capture many family members of family offices established several generations after the initial family wealth was created.

We are adopting, instead, an approach suggested in several comment letters that permits a family to choose a common ancestor (who may be deceased) and define family

21 Skadden Letter.

22 *See, e.g.*, Comment Letter of Foley & Lardner LLP (Nov. 18, 2010) ("Foley Letter"); Miller Letter; Comment Letter of Northern Trust (Nov. 18, 2010) ("Northern Trust Letter").

23 *See, e.g.*, Comment Letter of the American Institute of Certified Public Accountants (Nov. 16, 2010) ("AICPA Letter"); Comment Letter of The Blum Firm, P.C./Blum (Nov. 18, 2010) ("Blum Letter"); Comment Letter of Hogan Lovells US LLP (Nov. 18, 2010) ("Hogan Letter").

members by reference to the degree of lineal kinship to the designated relative.[24] This approach avoids any assumptions regarding the source of family wealth and the inconsistent treatment of extended family members compared to the approach we proposed.[25] In order to prevent families from choosing an extremely remote ancestor, which could allow commercial advisory businesses to rely on the rule, we are imposing a 10 generation limit between the oldest and youngest generation of family members. Such a limit, suggested by several commenters, would constrain the scope of persons considered family members while accommodating the typical number of generations served by most family offices.[26]

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24 *See, e.g.*, ABA Letter; Comment Letter of Duncan Associates (Nov. 18, 2010) ("Duncan Letter"); Comment Letter of Kozusko Harris Vetter Wareh LLP (Nov. 18, 2010) ("Kozusko Letter").

25 Moreover, the approach we are adopting has been used in other contexts to delimit members of a family for purposes of special regulatory treatment. *See, e.g.*, Section 1361(c)(1)(B) of the Internal Revenue Code of 1986, as amended (treating members of a family as a single shareholder of an S Corporation and defining family members as "a common ancestor, any lineal descendant of such common ancestor, and any spouse or former spouse of such common ancestor or any such lineal descendant" but providing that an "individual shall not be considered to be a common ancestor if, on the applicable date, the individual is more than 6 generations removed from the youngest generation of shareholders"); Nevada Revised Statutes section 669.042 (defining a family trust company subject to special trust company regulation as having family members within 10 degrees of lineal kinship or 9 degrees of collateral kinship to the designated relative); New Hampshire Revised Statutes section 392-B:1 (defining a family trust company subject to special banking regulation as having family members within 5 degrees of lineal kinship or 9 degrees of collateral kinship to a designated relative).

26 *See, e.g.*, ABA Letter (suggesting a 9 generation limit); Duncan Letter (recommending that the Commission follow that used for Nevada family trust companies, which allows for 10 degrees of lineal kinship and 9 degrees of collateral kinship and stating that other states' family trust company laws with fewer degrees of kinship allowed had resulted in some family office clientele being outside the limitations); Kozusko Letter (recommending 10 generations (but not counting minors as a separate generation from their parents) as a size that, based on its experience and client base and on studies of family businesses, would comfortably accommodate most family offices but that would not open up the family office to abuse as a disguised commercial enterprise); Northern Trust Letter (stating that of the over 400 family offices they represent, some are now focused on their fifth through seventh generations). We have determined not to include a

Under this approach, the family office will be able to choose the common ancestor and may change that designation over time such that the family office clientele is able to shift over time along with the family members served by the family office. A family office exempt under the rule with a common ancestor several generations up from current family members will be able to serve a greater number of current collateral family members but fewer future lineal members.

For example, G1 (who is deceased) founded a business and placed his fortune into a trust for the benefit of his heirs. G4 founded a family office to manage that wealth for the ever growing number of family members descended from G1 and treated G1 as the common ancestor for purposes of which family members the family office could advise under the exclusion. At the time G4 created the family office, current clients extended as far as G4's great-grandchildren (or G7). Over time the family grows and additional generations are born. Eventually, to allow the family office to serve later generations that would otherwise extend beyond the 10 generation limit, the family office redesignates its common ancestor to an individual in G3.[27] The family office can do this under rule 202(a)(11)(G)-1 because the rule does not specify which individual the common ancestor is and it does not specify that it always has to be the same common ancestor. As a result of this redesignation, the family office is able to advise clients two generations younger,

separate limit on degrees of permissible collateral kinship because, given our relatively expansive 10 generation lineal limit, a reasonable collateral limit would not in practice expand the range of family members covered by the rule.

[27] No formal documentation or procedure is required for designating or redesignating a common ancestor.

but would no longer be able to advise certain branches of G1's family tree without registering under the Advisers Act.[28]

The rule, as proposed, treats lineal descendants and their spouses, spousal equivalents, stepchildren, and adopted children as family members.[29] Most commenters generally supported our inclusion of spousal equivalents, stepchildren and children by adoption,[30] but two commenters[31] opposed the inclusion of spousal equivalents, invoking the Defense of Marriage Act ("DOMA").[32] Because the term "spouse" is not defined in the rule and a "spousal equivalent" is identified as a category of person, separate and distinct from a "spouse," that meets the definition of a "family member," we do not believe that the rule violates that Act.

In response to comments we have expanded the definition to include foster children and persons who were minors when another family member became their legal guardian.[33] We are persuaded by the commenters that argued that foster children and children in a guardianship relationship often have familial ties indistinguishable from that

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28 *See* Annex A for an illustration of the impact of redesignating the common ancestor.

29 Rule 202(a)(11)(G)-1(d)(6). As proposed, we are using the definition of spousal equivalent currently used under our auditor independence rules. *See* Proposing Release, *supra* note 2, at n.24.

30 *See, e.g.*, Coalition Letter; NY Bar Letter.

31 Comment Letter of Alliance Defense Fund (Nov. 18, 2010); Comment Letter of Thomas V. Cliff (Nov. 1, 2010).

32 1 U.S.C. 7. The Act provides that in "determining the meaning of any Act of Congress, or of any ruling, regulation, or interpretation of the various administrative bureaus and agencies of the United States…the word 'spouse' refers only to a person of the opposite sex who is a husband or wife."

33 *See, e.g.*, ABA Letter; Dechert Letter; Tannenbaum Letter.

of children and stepchildren, and that including such individuals would not cause the family office to resemble a typical commercial investment adviser.[34]

Finally, the rule treats former family members (*i.e.*, former spouses, spousal equivalents and stepchildren) as family members.[35] We had proposed permitting former family members to retain any investments held through the family office at the time they became a former family member, but to limit them from making any new investments through the family office.[36] Commenters pointed out that a former spouse's financial arrangements often remain intertwined with those of the family, particularly if they provide for children who remain family members.[37] Some argued that stepchildren of a divorced spouse may remain close to the family after the divorce.[38] We are persuaded by these arguments and have modified the definition of former family member to include stepchildren.[39]

b. *Involuntary Transfers*

As proposed, rule 202(a)(11)(G)-1 prevents an involuntary transfer of assets to a person who is not a family client (*e.g.*, a bequest to a friend of assets in a family office-

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34 *See, e.g.*, Hogan Letter; Tannenbaum Letter. Guardianship arrangements for adults, however, can raise unique conflicts and issues as compared to guardianships for minors that we believe are more appropriately addressed through an exemptive order process where the Commission can consider the specific facts and circumstances, than through a rule of general applicability.

35 Rule 202(a)(11)(G)-1(d)(4)(ii).

36 Proposed rule 202(a)(11)(G)-1(d)(2)(vi), and (d)(4).

37 *See, e.g.*, Comment Letter of Perkins Coie/Lindquist (Nov. 18, 2010) ("Lindquist Letter"); Comment Letter of Proskauer Rose LLP (Nov. 16, 2010).

38 *See, e.g.*, Coalition Letter; Comment Letter of Kramer Levin Naftalis & Frankel LLP (Nov. 17, 2010) ("Kramer Levin Letter").

39 Rule 202(a)(11)(G)-1(d)(7).

advised private fund) from causing the family office to lose its exclusion. Under the rule, a family office may continue to provide advice with respect to such assets following an involuntary transfer for a transition period of up to one year.[40] The transition period permits the family office to orderly transition that client's assets to another investment adviser or otherwise restructure its activities to comply with the Advisers Act.

We proposed to allow the family office to continue to advise a non-family client for four months following the transfer of assets resulting from the involuntary event.[41] A number of commenters argued that four months is an inadequate period of time to transition investment advice arrangements as a result of an involuntary transfer,[42] particularly for illiquid assets such as investments in private funds.[43] Some suggested that the family office be required to transfer the assets as soon as legally and practically feasible.[44] Others suggested that we treat involuntary transfers in the same manner as we had proposed treating former family members—permitting their existing investments to

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40 Rule 202(a)(11)(G)-1(b)(1).

41 Proposed rule 202(a)(11)(G)-1(b)(1).

42 *See, e.g.*, Comment Letter of Davis Polk (Nov. 18, 2010) ("Davis Polk Letter"); Fried Frank Letter.

43 *See, e.g.*, ABA Letter; Comment Letter of Withers Bergman LLP (Nov. 17, 2010) ("Withers Bergman Letter").

44 *See, e.g.*, Comment Letter of Barnes & Thornburg LLP ("as soon as legally and reasonably practical, or in the alternative, within one year"); Coalition Letter ("as soon as it is both legally and practically feasible, and in any event would have a grace period of at least one year").

remain with the family office but prohibiting new investments.[45] Still others suggested that the transfer period be lengthened to anywhere from one year to three years.[46]

After an involuntary transfer, such as a bequest, the office would no longer be providing advice solely to members of a single family, and after several such bequests the office could cease to operate in any way as a family office. Thus, we believe that relief for involuntary transfers must be temporary. We are persuaded, however, that the four month transition period we proposed would be inadequate and have extended the period to one year.[47]

c. *Family Trusts and Estates*

Rule 202(a)(11)(G)-1 treats as a family client certain family trusts established for testamentary and charitable purposes. We have expanded the types of trusts that may be treated as a family client in response to several comments that our proposal failed to take into account certain aspects of trust and estate planning.[48] As discussed in more detail

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45 *See, e.g.*, Fried Frank Letter; Comment Letter of Sidley Austin LLP (Nov. 18, 2010).

46 *See, e.g.*, AICPA Letter (1 year); Comment Letter of Bessemer Securities Corporation (Nov. 17, 2010) ("Bessemer Letter") (1 year); Davis Polk Letter (3 years); Dechert Letter (2 years); Hogan Letter (2 years); Comment Letter of Kleinberg, Kaplan, Wolff & Cohen, P.C. (Nov. 17, 2010) ("Kleinberg Letter") (2 years); Kramer Levin Letter (1 year).

47 The one year period would not begin to run until completion of the transfer of legal title to the assets resulting from the involuntary event. We note also that if the involuntary transferee does not receive investment advice about securities for compensation from the family office, then the availability of rule 202(a)(11)(G)-1 would be unaffected. For a discussion of the Commission's and the staff's views on when investment advice about securities for compensation is provided under the Advisers Act, see *Applicability of the Investment Advisers Act to Financial Planners,* Pensions *Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services*, Investment Advisers Act Release No. 1092 (Oct. 8, 1987) [52 FR 38400 (Oct. 16, 1987)] ("Release 1092").

48 *See* rule 202(a)(11)(G)-1(d)(4). Several commenters questioned whether the identity of the trustee matters under the rule. *See, e.g.*, Comment Letter of SchiffHardin LLP/Debra L. Stetter (Nov. 18, 2010) ("Schiff/Stetter Letter"); Comment Letter of Vinson & Elkins

below, these expansions accommodate common estate planning and charitable giving plans and do not suggest that the family office is engaging in a commercial enterprise.

Irrevocable trusts. The rule treats as a family client any irrevocable trust in which one or more family clients are the only *current* beneficiaries.[49] We proposed including as a family client any trust or estate existing for the *sole* benefit of one or more family clients.[50]

As suggested by commenters, the final rule disregards contingent beneficiaries of trusts, which commenters explained are often named in the event that all family members are deceased to prevent the trust from distributing assets to distant relatives or escheating to the state.[51] If the contingent beneficiary later becomes an actual beneficiary and is not a permitted current beneficiary of a family trust under the exclusion (such as a family friend), the rule's provisions concerning involuntary transfers allow for an orderly transition of investment advice regarding those assets away from the family office.

Also in response to commenters, the rule permits the family office to advise irrevocable trusts funded exclusively by one or more other family clients in which the only current beneficiaries, in addition to other family clients, are non-profit organizations, charitable foundations, charitable trusts, or other charitable organizations.[52] Several commenters noted that families often establish and fund trusts whose sole current

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LLP (Nov. 15, 2010). A trust that meets the conditions in the rule for qualifying as a family client is unaffected by whether the trust is managed by an independent trustee.

49 Rule 202(a)(11)(G)-1(d)(4)(vii).

50 Proposed rule 202(a)(11)(G)-1(d)(2)(iv).

51 *See, e.g.*, Comment Letter of Arnold & Porter LLP (Nov. 11, 2010); Bessemer Letter.

52 Rule 202(a)(11)(G)-1(d)(4)(viii).

beneficiaries are both family clients and public charities.[53] Such an entity may not be a "charitable trust" as a technical manner, but we see no reason for treating them differently under the rule from charitable trusts funded exclusively by family clients.

Other commenters argued that a trust should be permitted to have current beneficiaries that are not family clients and that the rule instead should merely require that the trust be for the primary benefit of one or more family clients.[54] These commenters argued that the family office's provision of investment advice to these kinds of trusts would not change the family office's character and that it is the trust that is the client of the family office, rather than the beneficiary. We disagree. Current beneficiaries of a trust are greatly affected by the nature and quality of investment advice provided to the trust and would be harmed if there were fraud committed by the family office in managing trust assets. Even if in small numbers, these individuals and entities stand to benefit substantially from the protections of the Advisers Act and do not necessarily have any family ties or investment sophistication to stand in the Act's stead.

Revocable Trusts. The rule also treats as a family client a revocable trust of which one or more family clients are the sole grantors.[55] Accordingly, a revocable trust may be advised by a family office relying on the rule regardless of whether the beneficiaries of the trust are family members. We received several comments that argued that revocable trusts should be treated differently than irrevocable trusts, since the grantor

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53 *See, e.g.*, Comment Letter of Jones Day (Nov. 11, 2010) ("Jones Day Letter"); Comment Letter of McDermott Will & Emery/Edwin C. Laurenson (Nov. 18, 2010) ("McDermott/Laurenson Letter").

54 *See, e.g.*, Comment Letter of Dorsey & Whitney LLP/Bruce A. MacKenzie (Nov. 17, 2010) ("Dorsey Letter"); McDermott/Laurenson Letter.

55 Rule 202(a)(11)(G)-1(d)(4)(ix).

of a revocable trust effectively controls the trust and the beneficiaries of the trust have no reasonable expectation of obtaining any benefit from the trust until the trust becomes irrevocable (generally upon the death of the grantor).[56] Therefore, the identity of the beneficiaries of the trust should not matter so long as one or more family clients are the sole grantors of the trust. We agree that in the case of a revocable trust, the contingent nature of any beneficiary's expectation that it will benefit from the trust's assets supports disregarding a revocable trust's beneficiaries under the exclusion, just as other contingent beneficiaries are disregarded.

Estates. The final rule treats as a family client an estate of a family member, former family member, key employee or former key employee.[57] As suggested by several commenters, this provision permits a family office to advise the executor of a family member's estate even if that estate will be distributed to (and thus be for the benefit of) non-family members.[58] The executor of an estate is acting in lieu of the deceased family client in managing and distributing the family client's assets. Therefore, advice to the executor is equivalent to providing advice to that family client.[59]

d. *Non-Profit and Charitable Organizations*

The rule treats as a family client any non-profit organization, charitable foundation, charitable trust (including charitable lead trusts and charitable remainder

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56 *See, e.g.*, Davis Polk Letter; Comment Letter of Lee & Stone (Nov. 17, 2010) ("Lee & Stone Letter").

57 Rule 202(a)(11)(G)-1(d)(4)(vi). For former key employees, the advice is subject to the condition contained in rule 202(a)(11)(G)-1(d)(4)(iv).

58 *See, e.g.*, ABA Letter; AICPA Letter.

59 *See, e.g.*, Comment Letter of K&L Gates/Paul T. Metzger (Nov. 17, 2010); Comment Letter of Levin Schreder & Carey Ltd (Nov. 18, 2010) ("Levin Schreder Letter").

trusts whose only current beneficiaries are other family clients and charitable or non-profit organizations), or other charitable organization, in each case funded exclusively by one or more other family clients.[60] We understand that some family offices currently advise charitable or non-profit organizations that have accepted funding from non-family clients.[61] So that these family offices have sufficient time to transition such advisory arrangements or restructure the charitable or non-profit organization, we are including a transition period of until December 31, 2013 before family offices have to comply with this aspect of the exclusion.[62]

We had proposed treating as a family client any charitable foundation, charitable organization, or charitable trust established and funded exclusively by one or more family members.[63] Some commenters recommended that the Commission change the requirement that charities be established and funded "by family members" to "by family clients" because they asserted that family charities are often established and funded by family trusts, corporations or estates, and not exclusively by family members.[64] We agree that making this change is consistent with our view of the scope of persons that should be permitted to be served by the family office. Several commenters also believed that we should not require that a charitable organization be established by family members or family clients in order to receive investment advice from the family office

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60 Rule 202(a)(11)(G)-1(d)(4)(v).

61 *See, e.g.*, Foley Letter; Comment Letter of Morgan, Lewis & Bockius LLP (Nov. 18, 2010) ("Morgan Lewis Letter").

62 Rule 202(a)(11)(G)-1(e)(1).

63 Proposed rule 202(a)(11)(G)-1(d)(2)(iii).

64 *See, e.g.*, Dorsey Letter; Levin Schreder Letter.

under the exclusion because in some cases such charitable organizations may have been originally established by distant relatives that do not currently qualify as "family members."[65] We agree that as long as all the funding currently held by the charitable organization came solely from family clients, the individuals or entities that originally established it are not of import for our policy rationale.[66] We have changed the rule accordingly.

A number of commenters stated that "charitable organization" can have varying meanings when considered under trust and estate law versus under tax law.[67] Some of these commenters suggested that we add the term "non-profit organization" to ensure that we capture what is generally considered a charitable organization under both trust and tax law and based on their view that, as long as the non-profit organization is solely funded by family clients, the family office providing it with investment advice under the exclusion should not be of concern as a policy matter.[68] We intended to broadly capture charitable and non-profit organizations as commonly understood under both trust law and tax law and have modified the rule as suggested. Other commenters asked that we clarify that charitable lead trusts and charitable remainder trusts are included as family clients

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65 *See, e.g.*, Comment Letter of Goodwin Procter LLP (Nov. 17, 2010) ("Goodwin Letter"); Comment Letter of Willkie Farr & Gallagher LLP (Nov. 17, 2010).

66 We note that only the actual contributions to the non-profit or charitable organization need be examined for this purpose, and not any income, gains or losses relating to those contributions. For purposes of determining whether funding provided by a non-family client to the non-profit or charitable organization is "currently held" by the organization, the non-profit or charitable organization may offset any spending by the organization occurring at any time in the year of that non-family client contribution or any subsequent year against the non-family client contribution (*i.e.*, the organization may treat the non-family client contributions as the first funding spent).

67 *See, e.g.*, Goodwin Letter; Kozusko Letter.

68 *See, e.g.*, Coalition Letter; Kozusko Letter.

under the exclusion.[69] The rule we are adopting today clarifies that such trusts are included if their sole current beneficiaries are other family clients and charitable or non-profit organizations and if they meet the terms of other charitable organizations that may be advised by the family office—namely that they are funded exclusively by other family clients.[70] We believe this treatment of charitable lead trusts and charitable remainder trusts ensures that they are treated consistently with other trusts and charitable or non-profit organizations under the exclusion.

Finally, several commenters stated that the Commission should permit the family office to provide investment advice under the exclusion to charitable organizations even if funded in part by non-family clients.[71] They argued that because the contributed assets will not be invested for the benefit of the donors, as long as the family controlled the charitable entity or was its substantial contributor, it served no public policy purpose to preclude third party contributions.[72] We are leaving this aspect of the proposal unchanged because a non-profit or charitable organization that currently holds non-family funding lacks the characteristics necessary to be viewed as a member of a family unit. Permitting such organizations to be advised by a family office would be inconsistent with

[69] *See, e.g.*, Dechert Letter; Fried Frank Letter. Charitable lead trusts are entities in which a charity receives payments from the trust for a specified period as a current beneficiary, but the remainder of the trust is distributed to specified beneficiaries. Charitable remainder trusts are entities in which specified individuals or entities receive payments from the trust for a specified period as a current beneficiary, but a charity receives the remainder of the trust.

[70] *See* our discussion about family trusts in section II.A.1.c of this Release.

[71] *See, e.g.*, Foley Letter; Kleinberg Letter.

[72] *See, e.g.*, Ropes & Gray Letter; Skadden Letter.

the exclusion's underlying rationale that recognizes that the Advisers Act is not designed to regulate families managing their own wealth.

As noted above, however, we do recognize that some non-profit or charitable organizations advised by family offices have accepted non-family client funding. Such organizations may need time to spend the non-family funding so that none of it is "currently held" by the organization or to transition advisory arrangements. The rule provides until December 31, 2013 before this condition to the exclusion becomes applicable to family offices (*i.e.*, if the only reason the family office would not meet the exclusion is because it advises a non-profit or charitable organization that currently holds non-family client funding, the family office generally may nevertheless rely on the exclusion until December 31, 2013).[73] To rely on this transition period, a non-profit or charitable organization advised by the family office must not accept any additional funding from any non-family clients after August 31, 2011, except that during the transition period the non-profit or charitable organization may accept funding provided in fulfillment of any pledge made prior to August 31, 2011.

e. *Other Family Entities*

To allow the family office to structure its activities through typical investment structures, rule 202(a)(11)(G)-1 treats as a family client any company, including a pooled investment vehicle, that is wholly owned, directly or indirectly, by one or more family clients and operated for the sole benefit of family clients.[74] Some commenters objected

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[73] Rule 202(a)(11)(G)-1(e)(1).

[74] Rule 202(a)(11)(G)-1(d)(4)(xi). Under rule 202(a)(11)(G)-1(d)(2), control is defined as the power to exercise a controlling influence over the management or policies of an entity, unless such power is solely the result of being an officer of such entity. If any of these companies are pooled investment vehicles, they must be exempt from registration

to the requirement in our proposal that these entities be wholly owned and controlled by, and operated for the sole benefit of, family clients to qualify for the exclusion.[75] These commenters generally suggested modifying this aspect of the family client definition to require only that the entity be majority owned *or* controlled and operated for the *primary* benefit of family clients or similar variations.[76] One commenter suggested such an expansion to allow employees of the family that do not qualify as "key employees" to have a management role in the entity.[77] Others believed that non-family clients more broadly should be able to have a greater role in family office-advised entities.[78]

We believe that the elements of ownership and benefit are important to ensuring that the policy objectives underlying the family office exclusion are preserved. If non-family clients own a portion of such an entity, they have a vested interest in how the assets of that entity are managed—it is the source of their ownership stake's value. This is also true of a non-family client who is a beneficiary of that entity. As long as the entity is wholly owned by and for the sole benefit of family clients, however, we agree that, as with family trusts and family charitable organizations, the entity having non-family client

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as an investment company under the Investment Company Act of 1940 because the Advisers Act requires that an adviser to a registered investment company must register. *See* 15 U.S.C. 80b-3a(a)(1)(B).

75 *See, e.g.*, Blum Letter; Kramer Levin Letter (suggesting that the requirement be modified to require only that the entity be controlled and 80% owned by family clients to qualify as a family client).

76 *See, e.g.*, Coalition Letter; Kramer Levin Letter. *See also* Levin Schreder Letter (suggesting that the entity be controlled and substantially owned (80%) by family clients); Miller Letter (suggesting that the entity be wholly owned or controlled by and operated for the primary benefit of family clients).

77 Morgan Lewis Letter.

78 *See, e.g.*, Kramer Levin Letter; Miller Letter.

control does not change that family clients are the ultimate beneficiaries of the investment advice, and thus we have eliminated the requirement for control by family clients in the final rule.

f. *Key Employees*

The final rule treats certain key employees of the family office, their estates, and certain entities through which key employees may invest as family clients so that they may receive investment advice from, and participate in investment opportunities provided by, the family office. More specifically, the final rule permits the family office to provide investment advice to any natural person (including any key employee's spouse or spousal equivalent who holds a joint, community property or other similar shared ownership interest with that key employee) who is (i) an executive officer, director, trustee, general partner, or person serving in a similar capacity at the family office or its affiliated family office or (ii) any other employee of the family office or its affiliated family office (other than an employee performing solely clerical, secretarial, or administrative functions) who, in connection with his or her regular functions or duties, participates in the investment activities of the family office or affiliated family office, provided that such employee has been performing such functions or duties for or on behalf of the family office or affiliated family office, or substantially similar functions or duties for or on behalf of another company, for at least twelve months.[79] The final rule also permits the family office to advise certain trusts of key employees, as further described below. Finally, in addition to receiving direct advice from the family office, key employees (because they are "family clients") may indirectly receive investment

[79] Rule 202(a)(11)(G)-1(d)(8).

advice through the family office by their investment in family office-advised private funds, charitable organizations, and other family entities, as described in previous sections of this Release.

Many commenters supported the inclusion of key employees as family clients.[80] They agreed that permitting investment participation by key employees of family offices would align their interests with those of family members and enable family offices to attract highly skilled investment professionals who may not otherwise be attracted to work at a family office.[81]

Some commenters, however, urged us to include key employees of family entities other than the family office as family clients.[82] Some reasoned that since the definition of key employee is based on the knowledgeable employee standard used in Investment Company Act rule 3c-5,[83] it should be expanded to cover key employees of any entity related to the family office because rule 3c-5 allows knowledgeable employees to be employees of certain affiliated entities.[84] Such an approach would extend Investment Company Act rule 3c-5 beyond its intended scope. That rule permits knowledgeable employees of affiliated entities to count as knowledgeable employees of the covered private fund *only* if the affiliated entity is participating in the investment activities of the

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80 *See*, *e.g.*, ABA Letter; Coalition Letter.

81 *Id.*

82 *See, e.g.*, Fried Frank Letter; NY Bar Letter; Skadden Letter.

83 *See* Proposing Release, *supra* note 2, at n.46 and accompanying text.

84 *See, e.g.*, NY Bar Letter; Skadden Letter.

covered private fund.[85] Because of this role, these individuals could be presumed to have sufficient financial sophistication, experience, and knowledge to evaluate investment risks and to take steps to protect themselves, even without the protection of the Investment Company Act.[86]

Many family entities advised by the family office, however, are not involved in providing investment advisory services to the family office or its clients and rather have principal business activities in a variety of industries unrelated to investment management. There is no reason to expect that their key employees have a level of knowledge and experience in financial matters sufficient to protect themselves without the protections afforded by the Advisers Act.[87] We agree, however, that if a person qualifies as a knowledgeable employee of an affiliated family office, that those employees should be in a position to protect themselves in receiving investment advice from a family office excluded from regulation under the Advisers Act.[88] We have modified the rule to include knowledgeable employees of an affiliated family office in the definition of key employee.[89]

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85 *See* Section III.B of *Privately Offered Investment Companies*, Investment Company Act Release 22597 (April 3, 1997) [62 FR 17512 (April 7, 1997)] ("3(c)(7) Release").

86 *See* 3(c)(7) Release, *supra* note 85, at Section III.A.2.B.

87 As we explained when we adopted rule 3c-5, employees who simply "obtain information" but do not "participate in" the investment activities of the fund are not included in the definition of knowledgeable employee because they may not have investment experience. *See* 3(c)(7) Release, *supra* note 85, at Section III.B.

88 Some commenters pointed out that a family may establish more than one family office for tax or other structuring reasons and recommended that the definition of key employee include employees of multiple family offices that serve the same family. *See, e.g.*, Davis Polk Letter; Fried Frank Letter.

89 Rule 202(a)(11)(G)-1(d)(8). "Affiliated family office" is defined as "a family office wholly owned by family clients of another family office and that is controlled (directly or

A few commenters suggested that we include as family clients long-term employees of the family, even if they do not meet the knowledgeable employee standard.[90] Expanding the family client definition in this way would exclude from the Advisers Act's protections individuals for whom we have no basis on which to conclude that they can protect themselves.[91] We therefore decline to make the change suggested by commenters.

We have made two other changes to definitions relating to key employees in response to recommendations from commenters. First, in response to commenters and to reduce uncertainty identified by commenters we have included a definition of "executive officer," which is virtually identical to the definition of the same term used in Advisers Act rule 205-3 and Investment Company Act rule 3c-5.[92] Similar to those rules, this

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indirectly) by one or more family members of such other family office and/or family entities affiliated with such other family office and has no clients other than family clients of such other family office." Rule 202(a)(11)(G)-1(d)(1).

90 *See, e.g.*, NY Bar Letter; Skadden Letter. Similarly, a few commenters suggested that we define key employees using the accredited investor standard from Regulation D under the Securities Act of 1933. *See, e.g.*, Comment Letter of Schulte Roth & Zabel LLP (Dec. 8, 2010); Lee & Stone Letter. We believe the knowledgeable employee standard more accurately encompasses employees that are likely to be financially sophisticated and to not need the protections of the Advisers Act.

91 Exemptive orders issued in the past 10 years generally did not permit family offices to provide investment advice to non-key employees. The two exemptive orders issued to family offices permitting such advice contained grandfathering provisions that restricted these employees' investments to the existing ones and prohibited the advisers from establishing new advisory relationships with a non-family member. *Adler Management, L.L.C.*, Investment Advisers Act Release Nos. 2500 (Mar. 21, 2006) [71 FR 15498 (Mar. 28, 2006)] (notice) and 2508 (Apr. 14, 2006) (order); *Longview Management Group LLC*, Investment Advisers Act Release Nos. 2008 (Jan. 3, 2002) [67 FR 1251 (Jan. 9, 2002)] (notice) and 2013 (Feb. 7, 2002) (order).

92 Commenters recommending this change include the Fried Frank Letter and the Skadden Letter. Paragraph (d)(3) of the rule, however, differs from rule 205-3 and section 3c-5 in that it does not include executives in charge of sales because such a function is not applicable to a family office.

definition delineates executive officers that should have enough financial experience and sophistication to invest without the protection of the Advisers Act. Second, the final rule clarifies that family clients include trusts of which the key employee generally is the sole contributor to the trust and the sole person authorized to make decisions with respect to the trust.[93]

Commenters recommended that we permit a trust established by a key employee with his or her lineal descendants or immediate family members as beneficiaries to be a family client, to allow typical estate planning by key employees.[94] We do not believe it is appropriate to broadly permit trusts for which the key employee is not the sole person authorized to make investment decisions to be a family client. Since a non-family client will be making investment decisions for this type of trust, and its beneficiaries are not family members or key employees, this type of trust stands to benefit from the protections of the Advisers Act. However, we are persuaded that it is appropriate to allow the family office to advise trusts for which the key employee is the sole person making investment decisions.[95] Permitting the family office to provide advice to this type of entity tracks a parallel concept included in the definition of "qualified purchaser" under the Investment Company Act[96] and thus creates consistency in entities considered not to need investor protection under our rules because investment decisions are made

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[93] Rule 202(a)(11)(G)-1(d)(4)(x). The grantor of the trust could also be a current or former spouse or spousal equivalent of the key employee if, at the time of contribution, the spouse or spousal equivalent held a joint, community property, or other similar shared ownership interest in the trust with the key employee.

[94] *See, e.g.*, Withers Bergman Letter (suggesting lineal descendants); Kleinberg Letter (suggesting immediate family members).

[95] Rule 202(a)(11)(G)-1(d)(4)(x).

[96] Section 2(a)(51)(A)(iii) of the Investment Company Act.

solely by individuals that we have already concluded should have sufficient financial experience and sophistication to act without the protection provided by our regulations.

Some commenters urged us to even further expand the definition of key employee to include their spouses and spousal equivalents (even if not with respect to joint property) or all of their immediate family members.[97] There is no reason to believe that the key employee's spouse or immediate family members independently have the financial sophistication and experience to protect themselves when receiving investment advice from the family office. Such individuals are not considered to be knowledgeable employees under Advisers Act rule 205-3 or Investment Company Act rule 3c-5. We see no basis for following a different approach in this context. The premise of the rule is to allow families to manage their own wealth. Key employee receipt of family office advice is permitted because their position and experience should enable them to protect themselves and to allow family offices to attract talented investment professionals as employees. This underlying rationale does not support as a general rule including key employees' family members unless there is a joint property interest involved.

Several commenters disagreed with the 12-month experience requirement for key employees who are not executive officers, directors, trustees, general partners, or persons serving in similar capacities of the family office, arguing that employees a family office would hire into these roles would presumably possess adequate knowledge and sophistication in financial matters regardless of whether he or she met the 12-month experience requirement.[98] We believe that the 12-month experience requirement is an

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[97] *See, e.g.*, Kleinberg Letter; Kramer Levin Letter.

[98] *See, e.g.*, ABA Letter; Comment Letter of Cadwalader, Wickersham & Taft LLP (Nov. 18, 2010) ("Cadwalader Letter").

important part of limiting employees who receive investment advice without the protections of the Advisers Act (or family membership) to those employees that are likely to be in a position or have a level of knowledge and experience in financial matters sufficient to be able to evaluate the risks and take steps to protect themselves. In addition, commenters' argument is equally applicable in a private fund or performance fee context, and we see no basis for distinguishing treatment of key employees of family offices from key employees of private funds or qualified client advisers under Investment Company Act rule 3c-5 and Advisers Act rule 205-3, respectively.[99] We therefore adopt this requirement as proposed.

Finally, as proposed, the final rule prohibits key employees (including their trusts and controlled entities) from making additional investments through the family office upon the end of the key employees' employment by the family office, but will not require former key employees to liquidate or transfer investments held through the family office to avoid imposing possible adverse tax or investment consequences that might otherwise result.[100] While some commenters supported this limitation,[101] one commenter expressed objections to it, asserting that former key employees of family offices often continue to have a close relationship with the family and it should be the family's decision whether to

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[99] This analysis is consistent with our analysis in the 3(c)(7) Release where we stated that the 12-month experience requirement was designed to limit investments to employees that have the requisite experience to appreciate the risks of investing in the fund. 3(c)(7) Release, *supra* note 85, at Section III.B. As is the case under rule 3c-5, an employee need not work for a particular family office for the entire 12-month period. The time performing substantially similar functions or duties by that employee for or on behalf of another company may be counted toward the 12 month requirement. *See* 3(c)(7) Release, *supra* note 85.

[100] Rule 202(a)(11)(G)-1(d)(4)(iv).

[101] *See, e.g.*, ABA Letter; Coalition Letter.

terminate their family office's services to them.[102] We are including key employees as family clients because their particular role in the family office causes us to believe that the employee should be in a position to protect him or herself without the need for the protections of the Advisers Act. Once the employee is no longer in that role, this policy rationale no longer holds true to the same degree. Accordingly, we are adopting this aspect of the rule as proposed.[103]

2. Ownership and Control

The final rule requires that, to qualify for the exclusion from regulation under the Advisers Act, the family office must be wholly owned by family clients and exclusively controlled, directly or indirectly, by one or more family members or family entities.[104] Our final rule expands who may own the family office from "family members," as proposed, to "family clients." However, the rule continues to require that control of the

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[102] Schiff/Stetter Letter.

[103] A number of commenters requested that we clarify the extent to which a family office could provide investment advice to an employee benefit plan or pension plan sponsored by the family office without registering under the Act. *See, e.g.*, Comment Letter of the American Benefits Council/Committee on the Investment of Employee Benefit Assets (Nov. 18, 2010); Coalition Letter; Withers Bergman Letter. In our view, a family office or other employer that merely establishes an employee benefit plan or pension plan and selects one or more investment advisers for that plan would not be an investment adviser subject to the Advisers Act because it would not be an "investment adviser" within the meaning of section 202(a)(11). A family office (as defined in rule 202(a)(11)(G)-1) thus would not be required to register under the Act if, in addition to providing advice to family clients, its advisory activities are so limited. However, a family office providing additional advisory services to an employee benefit plan all of whose participants are not family clients may be required to register under the Act unless another exemption is available.

[104] Rule 202(a)(11)(G)-1(b)(2). We have added the word "exclusively" to clarify that "control" cannot be shared with individuals or companies that are not family members or family entities. A family entity is defined as any of the trusts, companies or other entities set forth in paragraphs (v), (vi), (vii), (viii), (ix), or (xi) of subsection (d)(4) of rule 202(a)(11)(G)-1, but excluding key employees and their trusts from the definition of family client solely for purposes of this definition.

family office remain, directly or indirectly, with family members and their related entities.

Commenters urged us to expand both who could own the family office and who could control a family office under the rule.[105] Some stated that many family offices are owned by family trusts, and that allowing family members to indirectly own and control the family office did not provide sufficient clarity that such a trust could own and control the family office.[106] Commenters also pointed out that many family offices permit their employees to own equity interest in family offices as an incentive to attract and retain talented employees, and urged us not to prohibit such arrangements.[107] These commenters asked us to explicitly broaden the ownership requirement from "family members" to "family clients" to permit these types of arrangements. Other commenters argued more broadly that the "wholly owned and controlled" aspect of the proposed definition does not adequately reflect the variety of organizational arrangements already in place at family offices and that the Commission should focus as a policy matter solely on whether the family office is being operated for the benefit of members of a single family.[108]

Commenters persuaded us to expand who may own the family office from "family members" to "family clients." This change is consistent with the intent behind our proposed language (which contemplated that the family could own the family office

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105 *See, e.g.*, Coalition Letter; Comment Letter of McDermott Will & Emery/Richard L. Dees (Nov. 18, 2010) ("McDermott Dees Letter").

106 *See, e.g.*, Dorsey Letter; Comment Letter of McGuire Woods LLP (Nov. 18, 2010).

107 *See, e.g.*, AICPA Letter; Davis Polk Letter; Dechert Letter.

108 *See, e.g.*, Coalition Letter; Levin Schreder Letter; McDermott Dees Letter.

indirectly) and more clearly allows family members to structure their ownership of the family office for tax or other reasons. We also agree with suggestions that the rule permit key employees to own a non-controlling stake in the family office to serve as part of an incentive compensation package for key employees. We remain convinced, however, that for our core policy rationale to be fulfilled—that a family office is essentially a family managing its own wealth—the family, directly or indirectly, should control the family office. Accordingly, the final rule provides that while family clients may own the family office, family members and family entities (*i.e.*, their wholly owned companies or family trusts) must control the family office.[109]

3. Holding Out

As proposed, the final rule prohibits a family office relying on the rule from holding itself out to the public as an investment adviser.[110] Commenters supported this prohibition.[111] Holding itself out to the public as an investment adviser suggests that the family office is seeking to enter into typical advisory relationships with non-family

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[109] We note that, as proposed, we are not limiting the exclusion to a family office that is not operated for the purpose of generating a profit. We also note that some family offices may be structured such that all or a portion of family client investment gains are distributed as dividends from the family office (when family clients own the family office) and that a not-for-profit requirement would preclude this family office structure. We were persuaded by several commenters who cautioned against limiting the exclusion for family offices to those that operate on a not-for-profit basis, arguing that it would be difficult to administer and is unnecessary given the limited clientele that a family office may advise and rely on the exclusion. *See, e.g.*, AICPA Letter; Davis Polk Letter; Kozusko Letter.

[110] Rule 202(a)(11)(G)-1(b)(3). For purposes of this rule, despite language under rule 203(b)(3)-1(c) regarding holding out, a family office could not market non-public offerings to persons or entities that are not family clients since such activity would not be consistent with a family office that only provides investment advice to family clients and does not hold itself out to the public as an investment adviser.

[111] *See, e.g.*, Coalition Letter; ABA letter.

clients, and thus is inconsistent with the basis on which we have provided exemptive orders and are adopting this rule.[112]

4. Multifamily Offices

The exclusion we are adopting today does not extend to family offices serving multiple families, as urged by several commenters.[113] Comments we received did not persuade us that the rule could be drafted to distinguish in any meaningful way between such offices and family-owned commercial advisory firms that offer their services to other families.[114] Moreover, they did not persuade us that the protections of the Advisers Act, including the application of the anti-fraud provisions of the Act, would not be relevant to a family obtaining services from an office established by another family with which it could have conflicts of interest. Families, of course, may have conflicts among members leading to disputes. But, as discussed in our Proposing Release, the premise of the exclusion is that such disputes could be worked out within the family unit or, if necessary, by state courts under laws that facilitate resolution of family disputes. In a multifamily office, these clients would be without the protections of the Advisers Act or

112 *See* footnote 56 of the Proposing Release, *supra* note 2. In response to one commenter's request, we clarify that a family office that is currently registered as an investment adviser and expects to de-register in reliance on rule 202(a)(11)(G)-1, will not be prohibited from relying on the rule solely because it held itself out to the public as an investment adviser while it was registered under the Advisers Act. *See* Dechert Letter.

113 *See, e.g.*, Cadwalader Letter; Comment Letter of Lowenstein Sandler PC (Nov. 12, 2010); Comment Letter of Stradling Yocca Carlson & Rauth (Nov. 16, 2010).

114 We note that under section 208(d) of the Advisers Act, it is unlawful for any person indirectly to do anything that would be unlawful for such person to do directly under the Advisers Act or rules thereunder. Therefore, if several families that are unrelated through a common ancestor within 10 generations have established a separate family office for each of the families, but have staffed these family offices with the same or substantially the same employees such employees are managing a *de facto* multifamily office. As a result, these family offices may not claim the family office exclusion.

family relationships for preventing or handling any discriminatory or fraudulent treatment of different families.

B. Grandfathering Provisions, Transition Period and Effect of Rule on Previously Issued Exemptive Orders

The Dodd-Frank Act prohibits us from excluding from our definition of family office persons not registered or required to be registered on January 1, 2010 that would meet all of the required conditions under rule 202(a)(11)(G)-1 but for their provision of investment advice to certain clients specified in section 409(b)(3) of the Dodd-Frank Act.[115] We have incorporated this required grandfathering into paragraph (c) of our rule.[116] We received two comments on such incorporation. One commenter suggested that we incorporate the grandfathering provision only by reference to section 409(b)(3) of the Dodd-Frank Act.[117] We believe that incorporating the grandfathering provision of Dodd-Frank Act is a more user friendly approach for those attempting to comply with the Advisers Act compared to directing them to look up the grandfathering provision in a separate statute. Another commenter requested clarification of the Dodd-Frank grandfathering provision.[118] We believe clarification or interpretation of this provision would involve applying the provision to specific facts, and this release is not an

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115 *See* section 409(b)(3) and (c) of the Dodd-Frank Act.

116 We note that section 409(c) of the Dodd-Frank Act provides that "a family office that would not be a family office, but for section 409(b)(3) of the Dodd-Frank Act, shall be deemed to be an investment adviser for the purposes of paragraphs (1), (2) and (4) of section 206 of the Advisers Act." This provision is reflected in paragraph (3) of rule 202(a)(11)(G)-1(c).

117 Coalition Letter.

118 AICPA Letter.

appropriate means to provide such a clarification. Therefore, we are adopting paragraph (c) of the rule as proposed.

Several commenters suggested that we provide a transition period to allow family offices time to determine whether they meet the exclusion or to restructure or register under the Advisers Act if they do not.[119] We recognize that the time period between the adoption of this rule and the repeal of the private adviser exemption from registration contained in section 203(b)(3) of the Advisers Act, effective July 21, 2011, may not be sufficient for every family office to conduct such an evaluation, restructure or register. Accordingly, the rule provides that family offices currently exempt from registration under the Advisers Act in reliance on the private adviser exemption and that do not meet the new family office exclusion are not required to register with the Commission as investment advisers until March 30, 2012.[120] We believe that this aspect of the rule is necessary or appropriate in the public interest and is consistent with the protection of investors, and the purposes fairly intended by the policy and provisions of the Advisers Act.

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119 *See, e.g.*, Lee & Stone Letter (to provide time to restructure certain "club deals" in which clients of the family office may have engaged); Comment Letter of Paul, Hastings, Janofsky & Walker LLP (Nov. 17, 2010) (requesting an expanded grandfather provision to allow more time for an orderly restructuring); Ropes & Gray Letter.

120 Rule 202(a)(11)(G)-1(e)(2). *See also* Letter from Robert E. Plaze, Associate Director, Division of Investment Management, U.S. Securities and Exchange Commission, to David Massey, Deputy Securities Administrator, North Carolina Securities Division and President, NASAA (Apr. 8, 2011) *available at* http://www.sec.gov/rules/proposed/2010/ia-3110-letter-to-nasaa.pdf (stating that the Commission would potentially consider extending the date by which these advisers must register and come into compliance with the obligations of a registered adviser until the first quarter of 2012). Because initial applications for registration can take up to 45 days to be approved, family offices that determine they will need to register with the Commission should file a complete application, both Part 1 and a brochure(s) meeting the requirements of Part 2 of Form ADV, at least by February 14, 2012.

We have determined not to rescind exemptive orders previously issued to family offices under section 202(a)(11)(G) of the Advisers Act. As discussed above, the Commission has issued orders under section 202(a)(11)(G) of the Advisers Act to certain family offices declaring them and their employees acting within the scope of their employment to not be investment advisers within the intent of the Act. In some areas these exemptive orders may be slightly broader than the rule we are adopting today, and in other areas they may be narrower. We proposed not to rescind these exemptive orders and requested comment. All commenters addressing this subject supported our proposal. Thus, family offices currently operating under these orders may continue to rely on them.

III. PAPERWORK REDUCTION ACT

Rule 202(a)(11)(G)-1 does not contain a "collection of information" requirement within the meaning of the Paperwork Reduction Act of 1995.[121] Accordingly, the Paperwork Reduction Act is not applicable.

IV. ECONOMIC ANALYSIS

We are adopting rule 202(a)(11)(G)-1 in anticipation of the Dodd-Frank Act's repeal of section 203(b)(3) of the Advisers Act, which provides an exemption from registration for certain private fund advisers, and in light of the Dodd-Frank Act's directive that the Commission define family offices that will be excluded from regulation under the Advisers Act.[122] The rule we are adopting today defines a family office as a company that, with limited exceptions, has only family clients, is wholly owned by family clients and controlled by family members and/or family entities, and does not hold

[121] 44 U.S.C. 3501 *et seq.*

[122] *See* section 409 of the Dodd-Frank Act.

itself out to the public as an investment adviser. The definition of family office provided in the rule is designed to limit the exclusion from Advisers Act regulation solely to those private advisory offices that we believe the Advisers Act was not designed to regulate and to prevent circumvention of the Adviser Act's protections by firms that are operating as commercial investment advisory firms.

As a preliminary matter, and as discussed earlier, as a result of the repeal of section 203(b)(3) of the Advisers Act a number of private advisory offices that may consider themselves to be family offices and that are not currently registered as investment advisers in reliance on that provision will be required to register under the Advisers Act after July 21, 2011 unless those advisers are eligible for a new exemption. The benefits and costs associated with the elimination of section 203(b)(3) are attributable to the Dodd-Frank Act. However, while Congress also adopted a family office exclusion, it directed the Commission to adopt rules defining the terms of that exclusion, subject to the terms of section 409 of the Dodd-Frank Act, and thus we discuss below the costs and benefits of our determination of which private advisory offices are deemed family offices and therefore excluded from regulation.

In proposing the rule, we requested comment on all aspects of our cost benefit analysis, including the accuracy of our estimates of costs and benefits, identification and assessment of any costs and benefits not discussed in our analysis, and data relevant to these costs and benefits.[123] While some commenters predicted that many private advisory offices would have to restructure or apply for an exemptive order and thus incur

[123] Section V of the Proposing Release.

substantial costs if the definition of family office were not expanded,[124] no estimates of such costs were provided. We discuss these comments more specifically below.

A. Benefits

As discussed in the Proposing Release, we expect that rule 202(a)(11)(G)-1 will result in several important benefits. First, family offices, as defined by this rule, will not be subject to the mandatory costs of registering with the Commission as an investment adviser and the associated compliance costs. Some investment advisers currently registered with us may qualify as family offices under the rule and have the choice to deregister. These reduced regulatory costs should result in direct cost savings to these family offices, and thus to their family clients.

Second, the rule will benefit family offices, as defined by the rule, and their clients by eliminating the costs of seeking (and considering) individual exemptive orders. Without rule 202(a)(11)(G)-1, the repeal of the exemption contained in section 203(b)(3) would result in a great number of family offices having to apply for exemptive relief and thus incurring significant costs for these family offices and their clients. We estimate that a typical family office will incur legal fees of $200,000 on average to engage in the exemptive order application process, including preparation and revision of an application and consultations with Commission staff.[125] The rule will benefit family offices and their family clients by eliminating the costs of applying to the Commission for an exemptive order that the Commission would grant and the associated uncertainty that they might not obtain such an order. Estimates of the number of family offices in the United States vary

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[124] *See, e.g.*, Jones Day Letter; Withers Bergman Letter.

[125] We included the same estimate in the Proposing Release. We received no comments on this estimate.

widely—ranging from less than 1,000 to 5,000.[126] If all of these family offices qualify for the new exclusion and otherwise would have applied for an exemptive order, the rule will provide a benefit ranging from $200 million to $1 billion by eliminating the costs of applying for those exemptive orders.[127]

Finally, the rule also will benefit the Commission by freeing staff resources from reviewing and processing large numbers of family office exemptive applications resulting from the repeal of section 203(b)(3) of the Advisers Act that the Commission would grant and allowing the staff to target its work more efficiently, and thus will indirectly benefit public investors.

B. Costs

We recognize that some private advisory offices that today consider themselves to be family offices likely will incur expenses to evaluate whether they meet the terms of the exclusion. One commenter estimated that such an office would incur expenses of $25,000 to $35,000 to hire a consulting firm or law firm to determine if it meets the exclusion provided by the rule.[128] If all family offices estimated to exist in the United States noted above[129] hire a consulting firm or law firm to determine if they meet the

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126 *See, e.g.*, Pamela J. Black, *The Rise of the Multi-Family Office*, FINANCIAL PLANNING (Apr. 27, 2010) (estimating 2,500 to 3,000 single family offices); Robert Frank, *Minding the Money—'Family Office' Chiefs Get Plied with Perks; Club Membership, Jets*, THE WALL STREET JOURNAL (Sept. 7, 2007), at W2 (estimating 3,000 to 5,000 family offices in the United States); Second Annual Single-Family Office Study, the Family Wealth Alliance (2010) (estimating 2,500 U.S.-based single family offices); *Creating a Single Family Office for Wealth Creation and Family Legacy Sustainability*, Family Office Association (2009) (estimating 1,000 single family offices worldwide).

127 $200,000 cost of applying for an exemptive order multiplied by a range of 1,000 family offices to 5,000 family offices.

128 Lindquist Letter.

129 *See supra* note 126 and accompanying text.

exclusion at such a cost, they would incur an aggregate cost ranging from $25 million to $175 million for this evaluation.[130]

Some of these private advisory offices may decide to restructure their businesses to meet the conditions imposed by rule 202(a)(11)(G)-1. Many commenters stated that the proposed definition of family office was too narrow, and that if it was adopted without changes, absent an exemptive order, many such advisory offices would be required to restructure themselves in order to qualify as family offices.[131] Restructuring or obtaining an exemptive order, some commenters asserted, would result in substantial costs to the advisory office and its clients.[132] We expect that each such office will weigh the costs of such restructuring under its particular circumstances against the costs and burdens of registration or seeking an exemptive order.

Our final rule broadens the definition of "family client" and "family office" from that proposed, particularly concerning permissible clients of the family office and ownership of the family office.[133] As a result, we expect that substantially fewer private advisory offices will need to confront these trade-offs than would have been the case under our proposal. Nevertheless, we recognize that some offices may decide to restructure their businesses in order to meet even the expanded family office definition under the final rule, rather than register or seek an exemptive order. The costs of any such restructuring will be highly dependent on the nature and extent of the restructuring,

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130 ($25,000 evaluation cost) x (1,000 family offices) = $25 million. ($35,000 evaluation cost) x (5,000 family offices) = $175 million.

131 *See, e.g.*, Lindquist Letter; Lee & Stone Letter; Withers Bergman Letter.

132 *See, e.g.*, Coalition Letter; Lee & Stone Letter.

133 *See* Section II of this Release for discussion of these expansions.

which we understand may vary significantly from office to office. No commenters provided an estimate of the costs to carry out any necessary restructuring.

We do not expect that the rule will impose any significant costs on family offices currently operating under a Commission exemptive order. We are permitting these family offices to continue to rely on their exemptive orders. They may choose, of course, to qualify for exclusion under the rule. We expect that most of these family offices will satisfy all the conditions of the rule without changing their structure or operations. However, these family offices may incur one-time "learning costs" in determining the differences between their orders and the rule. We estimate that such costs will be no more than $5,000 on average for a family office if it hires an external consulting firm or law firm to assist in determining the differences. Because the terms of these advisers' exemptive orders were similar to rule 202(a)(11)(G)-1, these family offices should incur significantly lower costs to evaluate the new rule than family offices that do not have an exemptive order. There are 13 family offices that have obtained exemptive orders. Accordingly, we estimate that these family offices collectively would incur outside consulting or legal expenses of $65,000 to discern the differences between their orders and the rule.

Finally, if there were any family offices that previously registered with the Commission, but now may de-register in reliance on the new family office exclusion in the Advisers Act, the rule may have competitive effects on investment advisers that may compete with the family office for the provision of investment management services to family clients since these third party investment advisers would bear the regulatory costs associated with compliance with the Advisers Act or state investment adviser regulatory requirements. We do not expect that the rule will impact capital formation.

V. FINAL REGULATORY FLEXIBILITY ANALYSIS

The Commission has prepared the following Final Regulatory Flexibility Analysis ("FRFA") regarding rule 202(a)(11)(G)-1 in accordance with section 604 of the Regulatory Flexibility Act.[134] We prepared an Initial Regulatory Flexibility Analysis ("IRFA") in conjunction with the Proposing Release in October 2010.[135]

A. Need for the Rule

We are adopting rule 202(a)(11)(G)-1 defining family offices excluded from regulation under the Advisers Act because we are required to do so under section 409 of the Dodd-Frank Act.

B. Significant Issues Raised by Public Comment

In the Proposing Release, we requested comment on the IRFA. None of the comment letters we received specifically addressed the IRFA. None of the comment letters made specific comments about the proposed rule's impact on smaller family offices.

C. Small Entities Subject to the Rule

Under Commission rules, for purposes of the Advisers Act and the Regulatory Flexibility Act, an investment adviser generally is a small entity if it: (i) has assets under management having a total value of less than $25 million; (ii) did not have total assets of $5 million or more on the last day of its most recent fiscal year; and (iii) does not control, is not controlled by, and is not under common control with another investment adviser that has assets under management of $25 million or more, or any person (other than a

---

134 5 U.S.C. 604(a).

135 *See* Proposing Release, *supra* note 2, at Section VI.

natural person) that had $5 million or more on the last day of its most recent fiscal year.[136]

We do not have data and are not aware of any databases that compile information regarding how many family offices will be a small entity under this definition, but since family offices only are established for the very wealthy and given the statistics included in the Proposing Release showing that they generally serve families with at least $100 million or more of investable assets and have an average net worth of $517 million, we believe it is unlikely that any family offices would be small entities.[137]

D. Projected Reporting, Recordkeeping, and other Compliance Requirements

Rule 202(a)(11)(G)-1 imposes no reporting, recordkeeping or other compliance requirements.

E. Agency Action to Minimize Effect on Smaller Entities

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant impact on small entities. In connection with the rule, the Commission considered the following alternatives: (i) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (ii) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for small entities; (iii) the use of performance rather than

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136 17 CFR 275.0-7(a).

137 *See* Proposing Release, *supra* note 2, at n.2 and accompanying text. One commenter (Comment Letter of Robert Stenson (Oct. 18, 2010)) cited a 1999 survey which estimated that 32% of family offices had investment assets of less than $100 million. However, this commenter did not indicate how many family offices had assets under management of less than $25 million and thus qualified as "small entities" as defined in Advisers Act rule 0-7, *supra* note 136 and accompanying text.

design standards; and (iv) an exemption from coverage of the rule, or any part thereof, for small entities.

Rule 202(a)(11)(G)-1 is exemptive and compliance with the rule is voluntary. We therefore do not believe that different or simplified compliance, timetable, or reporting requirements, or an exemption from coverage of the rule for small entities, is appropriate. The conditions in the rule are designed to ensure that family offices operating under the rule provide advice only to the family itself and not the general public and, accordingly, the protections of the Advisers Act are not warranted. Reducing these conditions for smaller family offices would be inconsistent with the policy underlying the exclusion and would harm investor protection.

Our prior exemptive orders have not made any differentiation based on the size of the family office. In addition, as discussed above, we expect that very few, if any, family offices are small entities. The Commission also believes that rule 202(a)(11)(G)-1 will decrease burdens on small entities by making it unnecessary for most of them to seek an exemptive order from the Commission to operate without registration under the Advisers Act. As a result, we do not anticipate that the potential impact of the rule on small entities will be significant.

The rule specifies broad conditions with which a family office must comply to rely on the exclusion; the rule leaves to each family office how to structure its specific operations to meet these conditions. The rule thus already incorporates performance rather than design standards. For these reasons, alternatives to the rule appear unnecessary and in any event are unlikely to minimize any impact that the rule might have on small entities.

VI. STATUTORY AUTHORITY

We are adopting rule 202(a)(11)(G)-1 [17 CFR 275.202(a)(11)(G)-1] pursuant to our authority set forth in sections 202(a)(11)(G) and 206A of the Advisers Act [15 U.S.C. 80b-2(a)(11)(G) and 80b-6A].

LIST OF SUBJECTS IN 17 CFR PART 275

Reporting and recordkeeping requirements, Securities.

TEXT OF RULE

For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is amended as follows.

PART 275 – RULES AND REGULATIONS, INVESTMENT ADVISERS ACT OF 1940

1. The authority citation for Part 275 continues to read in part as follows:

Authority: 15 U.S.C. 80b-2(a)(11)(G), 80b-2(a)(17), 80b-3, 80b-4, 80b-4a, 80b-6(4), 80b-6a, and 80b-11, unless otherwise noted.

* * * * *

2. Section 275.202(a)(11)(G)-1 is added to read as follows:

§ 275.202(a)(11)(G)-1 Family offices.

(a) *Exclusion*. A family office, as defined in this section, shall not be considered to be an investment adviser for purpose of the Act.

(b) *Family office.* A family office is a company (including its directors, partners, members, managers, trustees, and employees acting within the scope of their position or employment) that:

(1) Has no clients other than family clients; provided that if a person that is not a family client becomes a client of the family office as a result of the death of a

family member or key employee or other involuntary transfer from a family member or key employee, that person shall be deemed to be a family client for purposes of this section 275.202(a)(11)(G)-1 for one year following the completion of the transfer of legal title to the assets resulting from the involuntary event;

(2) Is wholly owned by family clients and is exclusively controlled (directly or indirectly) by one or more family members and/or family entities; and

(3) Does not hold itself out to the public as an investment adviser.

(c) *Grandfathering*. A family office as defined in paragraph (a) above shall not exclude any person, who was not registered or required to be registered under the Act on January 1, 2010, solely because such person provides investment advice to, and was engaged before January 1, 2010 in providing investment advice to:

(1) Natural persons who, at the time of their applicable investment, are officers, directors, or employees of the family office who have invested with the family office before January 1, 2010 and are accredited investors, as defined in Regulation D under the Securities Act of 1933;

(2) Any company owned exclusively and controlled by one or more family members; or

(3) Any investment adviser registered under the Act that provides investment advice to the family office and who identifies investment opportunities to the family office, and invests in such transactions on substantially the same terms as the family office invests, but does not invest in other funds advised by the family office, and whose assets as to which the family office directly or indirectly provides investment advice represents, in the aggregate, not more than 5 percent of the value of the total assets as to

which the family office provides investment advice; provided that a family office that would not be a family office but for this subsection (c) shall be deemed to be an investment adviser for purposes of paragraphs (1), (2) and (4) of section 206 of the Act.

(d) *Definitions*. For purposes of this section:

(1) *Affiliated Family Office* means a family office wholly owned by family clients of another family office and that is controlled (directly or indirectly) by one or more family members of such other family office and/or family entities affiliated with such other family office and has no clients other than family clients of such other family office.

(2) *Control* means the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of being an officer of such company.

(3) *Executive officer* means the president, any vice president in charge of a principal business unit, division or function (such as administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions, for the family office.

(4) *Family client* means:

(i) Any family member;

(ii) Any former family member;

(iii) Any key employee;

(iv) Any former key employee, provided that upon the end of such individual's employment by the family office, the former key employee shall not receive investment advice from the family office (or invest additional assets with a family office-advised trust, foundation or entity) other than with respect to assets advised (directly or indirectly) by the family office immediately prior to the end of such individual's employment, except that a former key employee shall be permitted to receive investment advice from the family office with respect to additional investments that the former key employee was contractually obligated to make, and that relate to a family-office advised investment existing, in each case prior to the time the person became a former key employee.

(v) Any non-profit organization, charitable foundation, charitable trust (including charitable lead trusts and charitable remainder trusts whose only current beneficiaries are other family clients and charitable or non-profit organizations), or other charitable organization, in each case for which all the funding such foundation, trust or organization holds came exclusively from one or more other family clients;

(vi) Any estate of a family member, former family member, key employee, or, subject to the condition contained in paragraph (d)(4)(iv) of this section, former key employee;

(vii) Any irrevocable trust in which one or more other family clients are the only current beneficiaries;

(viii) Any irrevocable trust funded exclusively by one or more other family clients in which other family clients and non-profit organizations, charitable foundations, charitable trusts, or other charitable organizations are the only current beneficiaries;

(ix) Any revocable trust of which one or more other family clients are the sole grantor;

(x) Any trust of which: (A) each trustee or other person authorized to make decisions with respect to the trust is a key employee; and (B) each settlor or other person who has contributed assets to the trust is a key employee or the key employee's current and/or former spouse or spousal equivalent who, at the time of contribution, holds a joint, community property, or other similar shared ownership interest with the key employee; or

(xi) Any company wholly owned (directly or indirectly) exclusively by, and operated for the sole benefit of, one or more other family clients; provided that if any such entity is a pooled investment vehicle, it is excepted from the definition of "investment company" under the Investment Company Act of 1940.

(5) *Family entity* means any of the trusts, estates, companies or other entities set forth in paragraphs (v), (vi), (vii), (viii), (ix), or (xi) of subsection (d)(4) of this section, but excluding key employees and their trusts from the definition of family client solely for purposes of this definition.

(6) *Family member* means all lineal descendants (including by adoption, stepchildren, foster children, and individuals that were a minor when another family member became a legal guardian of that individual) of a common ancestor (who may be living or deceased), and such lineal descendants' spouses or spousal equivalents; provided that the common ancestor is no more than 10 generations removed from the youngest generation of family members.

(7) *Former family member* means a spouse, spousal equivalent, or stepchild that was a family member but is no longer a family member due to a divorce or other similar event.

(8) *Key employee* means any natural person (including any key employee's spouse or spouse equivalent who holds a joint, community property, or other similar

shared ownership interest with that key employee) who is an executive officer, director, trustee, general partner, or person serving in a similar capacity of the family office or its affiliated family office or any employee of the family office or its affiliated family office (other than an employee performing solely clerical, secretarial, or administrative functions with regard to the family office) who, in connection with his or her regular functions or duties, participates in the investment activities of the family office or affiliated family office, provided that such employee has been performing such functions and duties for or on behalf of the family office or affiliated family office, or substantially similar functions or duties for or on behalf of another company, for at least 12 months.

(9) *Spousal equivalent* means a cohabitant occupying a relationship generally equivalent to that of a spouse.

(e) *Transition.*

(1) Any company existing on July 21, 2011 that would qualify as a family office under this section but for it having as a client one or more non-profit organizations, charitable foundations, charitable trusts, or other charitable organizations that have received funding from one or more individuals or companies that are not family clients shall be deemed to be a family office under this section until December 31, 2013, provided that such non-profit or charitable organization(s) do not accept any additional funding from any non-family client after August 31, 2011 (other than funding received prior to December 31, 2013 and provided in fulfillment of any pledge made prior to August 31, 2011).

(2) Any company engaged in the business of providing investment advice, directly or indirectly, primarily to members of a single family on July 21, 2011, and that

is not registered under the Act in reliance on section 203(b)(3) of this title on July 20, 2011, is exempt from registration as an investment adviser under this title until March 30, 2012, provided that the company:

(1) During the course of the preceding twelve months, has had fewer than fifteen clients; and

(2) Neither holds itself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a), or a company which has elected to be a business development company pursuant to section 54 of that Act (15 U.S.C. 80a-54) and has not withdrawn its election.

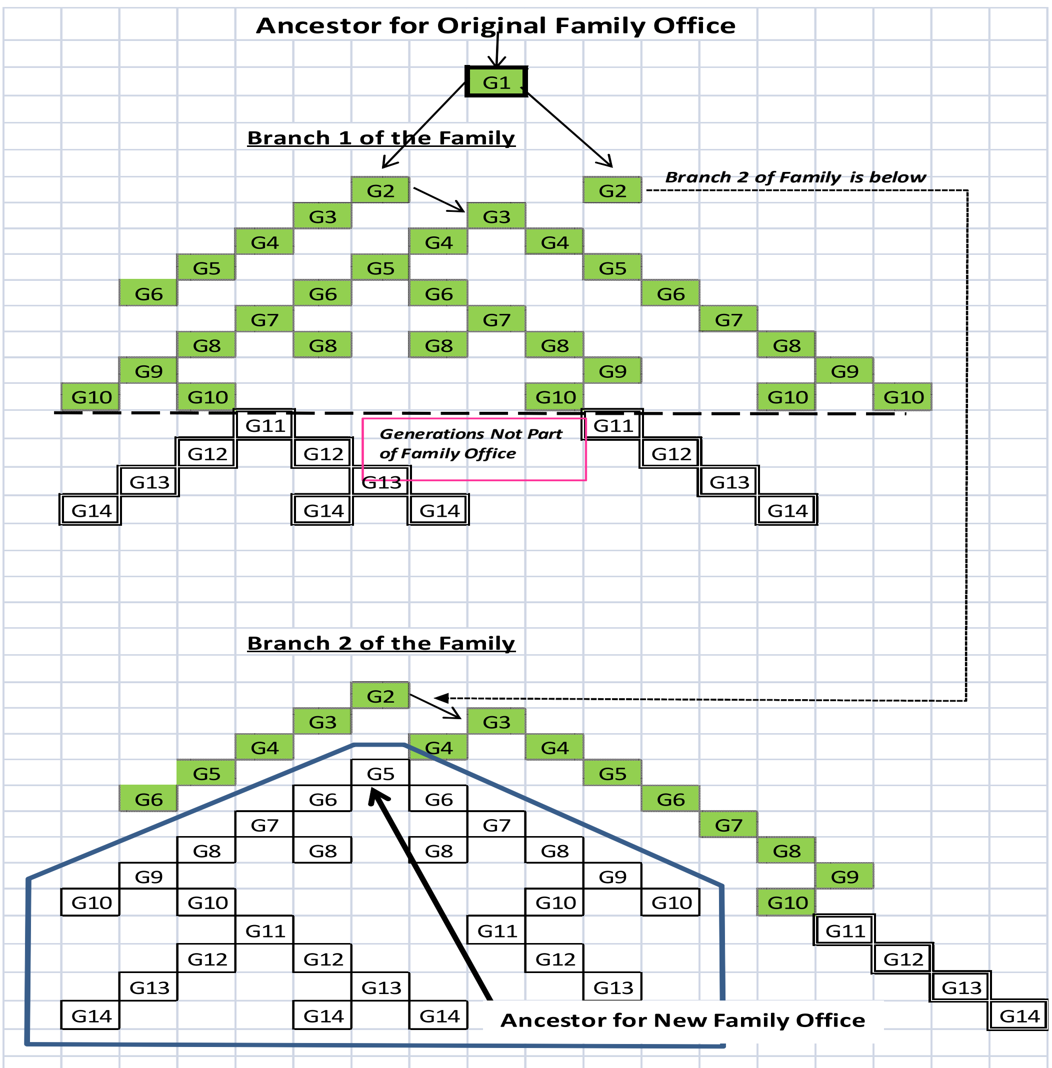
By the Commission.

Elizabeth M. Murphy
Secretary

June 22, 2011

Annex A

The following diagram illustrates the effect of a family office redesignating its common ancestor. In the first chart, the green/shaded boxes indicate persons in various generations that are "family members" of the family office. The double-outlinedboxes indicate persons in various generations that are outside the 10-generation limit and thus may not be advised by the family office under the exclusion. The lower diagram shows the impact of redesignating the common ancestor from an individual in generation 1 to an individual in generation 5. The single-outlined boxes indicate the new group of family clients that the family office may advise and maintain its exclusion. The green/shaded boxes indicate individuals that previously the family office could advise, but that are no longer "family members" due to the redesignation. The double-outlined boxes indicate individuals that were too remote from the common ancestor in both cases to be considered "family members."



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Consumer Protection Data Spotlight
FTC reporting back to you

Cryptocurrency buzz drives record investment scam losses

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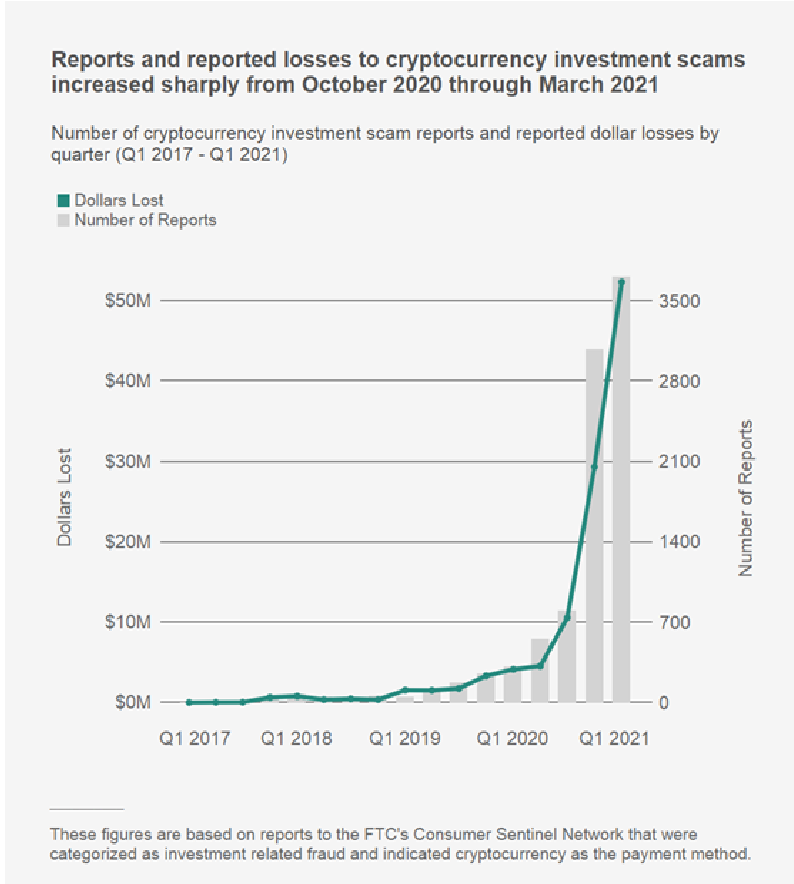
Emma Fletcher
May 17, 2021

Investing in cryptocurrency means taking on risks, but getting scammed shouldn't be one of them. Reports to the FTC's Consumer Sentinel[1] suggest scammers are cashing in on the buzz around cryptocurrency and luring people into bogus investment opportunities in record numbers. Since October 2020, reports have skyrocketed, with nearly 7,000 people reporting losses of more than $80 million on these scams.[2] Their reported median loss? $1,900. Compared to the same period a year earlier, that's about twelve times the number of reports and nearly 1,000% more in reported losses.[3]

Some say there's a Wild West vibe to the crypto culture, and an element of mystery too. Cryptocurrency enthusiasts congregate online to chat about their shared passion. And with bitcoin's value soaring in recent months, new investors may be eager to get in on the action. All of this plays right into the hands of scammers. They blend into the scene with claims that can seem plausible because cryptocurrency is unknown territory for many people. Online, people may appear to be friendly and willing to share their "tips." But that can also be part of the ruse to get people to invest in their scheme. In fact, some of these schemes are based on referral chains, and work by bringing in people who then recruit new "investors."

Many people have reported being lured to websites that look like opportunities for investing in or mining cryptocurrencies, but are bogus. They often offer several investment tiers – the more you put in, the bigger the supposed return. Sites use fake testimonials and cryptocurrency jargon to appear credible, but promises of enormous, guaranteed returns are simply lies. These websites may even make it look like your investment is growing. But people report that, when they try to withdraw supposed profits, they are told to send even more crypto – and end up getting nothing back.

Then, there are “giveaway scams,” supposedly sponsored by celebrities or other known figures in the cryptocurrency space, that promise to immediately multiply the cryptocurrency you send. But, people report that they discovered later that they’d simply sent their crypto directly to a scammer’s wallet. For example, people have reported sending more than $2 million in cryptocurrency to Elon Musk impersonators over just the past six months.



Scammers even use online dating to draw people into cryptocurrency investment scams. Many people have reported believing they were in a long-distance relationship when their new love started chatting about a hot cryptocurrency opportunity, which they then acted on. About 20% of the money people reported losing through romance scams since October 2020 was sent in cryptocurrency, and many of these reports were from people who said they thought they were investing.[4]

Since October 2020, people ages 20 to 49 were over five times more likely to report losing money on cryptocurrency investment scams than older age groups.[5] The numbers are especially striking for people in their 20s and 30s: this group reported losing far more money on investment scams than on any other type of fraud,[6] and more than half of their reported investment scam losses were in cryptocurrency.[7] In contrast, people 50 and older were far less likely to report losing money on cryptocurrency investment scams. But when this group did lose money on these scams, their reported individual losses were higher, with a median reported loss of $3,250.

To be clear, while investment scams top the list as the most lucrative way to obtain cryptocurrency, scammers will use whatever story works to get people to send crypto. That often involves impersonating a government authority or a well-known business. For example, many people have told the FTC they loaded cash into Bitcoin ATM machines to pay imposters claiming to be from the Social Security Administration. Others reported losing money to scammers posing as Coinbase, a well-known cryptocurrency exchange. In fact, 14% of reported losses to imposters of all types are now in cryptocurrency.[8]

Here are some things to know to play it safe(er) when it comes to cryptocurrency:

> Promises of guaranteed huge returns or claims that your cryptocurrency will be multiplied are always scams.
>
> The cryptocurrency itself *is* the investment. You make money if you’re lucky enough to sell it for more than you paid. Period. Don’t trust people who say they know a better way.
>
> If a caller, love interest, organization, or anyone else insists on cryptocurrency, you can bet it’s a scam.

To learn more about cryptocurrency scams, visit ftc.gov/cryptocurrency. If you spot a scam, report it to the FTC at ReportFraud.ftc.gov.

1 This Spotlight is based on reports from consumers to the FTC or to any Consumer Sentinel Network data contributor.

2 This figure is based on 6,792 cryptocurrency investment scam reports submitted from October 1, 2020 through March 31, 2021. Cryptocurrency investment scam reports here and throughout this Spotlight are defined as reports categorized as investment related fraud that indicate cryptocurrency as the payment method. The investment related fraud category includes the following fraud subcategories: art, gems and rare coin investments, investment seminars and advice, stocks and commodity futures trading, and miscellaneous investments. About 92% of cryptocurrency investment scam reports from October 1, 2020 through March 31, 2021 are classified as miscellaneous investments.

3 From October 1 2019 through March 31, 2020, people submitted 570 cryptocurrency investment scam reports indicating $7.5 million in total losses.

4 This figure is based reports submitted from October 1, 2020 through March 31, 2021 that were classified as romance scams. Reports that did not specify a payment method are excluded. Of these, 1,147 reports totaling $35 million in reported losses indicated cryptocurrency as the payment method. These reports are distinct from reports classified as investment related fraud, with no overlap between the two.

5 About 86% of cryptocurrency investment related fraud reports submitted from October 1, 2020 through March 31, 2021 included age information. This age comparison is normalized based on the number of loss reports per million population by age during this period. Population numbers were obtained from the U.S. Census Bureau Annual Estimates of the Resident Population for Selected Age Groups by Sex for the United States (June 2020).

6 This ranking is based on a comparison of Sentinel fraud subcategories. From October 1, 2020 through March 31, 2021, consumers ages 20-39 reported $114 million in total losses on frauds classified as miscellaneous investments. Excluding unspecified reports, the subcategory with second highest reported losses by this age group was online shopping with $64 million in reported losses. These figures are not limited to reports indicating cryptocurrency as the payment method.

7 This figure is based on reports submitted from October 1, 2020 through March 31, 2021 that were categorized as investment related fraud and indicated a consumer age of range of 20 to 39. Reports that did not specify a payment method are excluded. Of these, 3,581 reports totaling $35 million in reported losses indicated cryptocurrency as the payment method.

8 This figure is based on reports from October 1, 2020 through March 31, 2021 that were categorized as imposter scams. Reports that did not specify a payment method are excluded. Of these, 3,494 reports totaling $64 million in reported losses indicated cryptocurrency as the payment method. The imposter scams category includes the following fraud subcategories: business imposters, family and friend imposters, government imposters, romance scams, and tech support scams.

Cryptocurrency Spotlight (263.45 KB)

ftc.gov

SEC V. RIPPLE: WHY IS THE LAWSUIT TAKING SO LONG?

JULY 8, 2021 11:14 AM UTC, RICK STEVES

The answer might not ease the impatience, but it offers perspective on the United States legal system.

We at FinanceFeeds have noticed a recent surge of visitors towards our piece "SEC v. Ripple: When will the lawsuit end?", which possibly indicates growing anxiety among the wider trading industry, with the XRP community of stakeholders suffering the most.

The lawsuit filed in December 2020 has pressured cryptocurrency exchanges in the United States to delist the crypto asset developed by Ripple Labs and has probably made many potential customers, including banks and central banks, hesitant to sign up for their services while the lawsuit lingers.

The question "Why is the lawsuit taking so long?" has also spread across social media and attorney James K. Filan, one of the XRP community's favorite lawyers, provided an answer. It might not ease the impatience, but it offers perspective on the United States legal system.

> "This is not the only case Judges Torres and Netburn have to work on. Statistics show that Judge Torres has almost 700 cases pending at any given time. Many of those are civil cases where there will be lots of motion practice, as in this case."
>
> "Judge Torres also has many criminal cases and under the Constitution those take precedence. There are motions, hearings, trials, and sentencings in all of those cases too. There is a backlog of all cases because the courts have been closed on and off for the past year."
>
> "Finally, these judges work their asses off. You saw that when Judge Netburn issued a ruling on the Sunday before Memorial Day. I'm sure they are both trying hard to get things done right and quickly. But done right comes before done quickly. We all have to have some patience."

As to **WHEN**, the case is likely to be decided at summary judgment in early 2022, according to attorney Jeremy Hogan's calculations.

The two main issues that should put an end to the case are Ripple's fair notice defense and whether XRP is a security or not.

Regarding the Fair Notice Defense, the SEC has recently warned the Court that a Ripple win would nullify the Howie Test – the benchmark that has come under scrutiny with the emergence of the digital asset class. Ripple has partnered with Rutgers Law School to push for reform.

A Ripple win on the Fair Notice could not only have a significant impact on Ripple and XRP but also on the crypto ecosystem as a whole and even partially defund the SEC.

On the nature of XRP, the SEC has been claiming the asset is a security due to its centralized nature. Ripple, on the other hand, has kept proposing new use cases for the ledger – which is a sign of utility.

Regarding the status of XRP, Ripple Labs subpoenaed William Hinman to offer his deposition and clarify the SEC's internal views and policy decision-making, among other issues.

The former Director of the SEC's Division of Corporate Finance has publicly stated that Ethereum, as well as Bitcoin, are not securities.

Although the SEC is attempting to quash that subpoena, many experts close to the lawsuit believe he will be called to depose. The SEC has previously said his speech on Ethereum and Bitcoin were his own personal views, not necessarily of the SEC.

Mounting pressure on the SEC could, however, motive the financial watchdog to provide its official view on the status of Ethereum once its upgrade, ETH2, goes live. This would help the regulator sound more coherent with its own legal arguments in the SEC v. Ripple case.

Such a decision could be a turn of events for Ethereum as the new upgrade gets even closer to a security status, according to the Howie test and the SEC's past enforcement actions.

You might also want to read:

Will the Ripple lawsuit turn against Ethereum with the SEC revisiting its status?

Can the Ripple lawsuit turn against Ethereum?

SEC finds Ripple's argument "ironic" in bid to avoid controversial deposition

BTC, ETH, ETH2, USDT, BNB, ADA, DOGE, DOT, UNI: Who's next after the SEC is through with Ripple's XRP?

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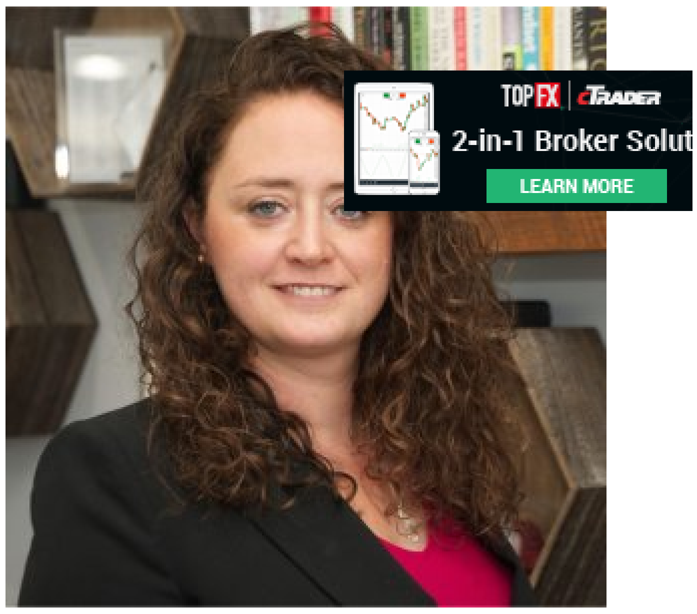

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SEC WARNS COURT THAT A RIPPLE WIN ON FAIR NOTICE DEFENSE WOULD NULLIFY HOWIE TEST

JUNE 10, 2021 7:00 PM UTC, RICK STEVES

Earlier this week, Ripple filed a SurReply that argues that the "more than seventy" lawsuits brought by the SEC against cryptocurrency firms don't serve as Fair Notice for Ripple Labs.

This SurReplay – made public on Twitter by attorney James K. Filan – responds to the Securities and Exchange Commission's reply supporting its motion to strike Ripple's fourth affirmative defense: lack of fair notice.

"In its Reply, the SEC relies on a report by Cornerstone Research, a private consulting firm, to argue for the first time that Ripple's fair notice defense "fails" because, "[p]rior to suing Ripple, the SEC had already brought more than seventy cases that subjected other digital assets to the application of the federal securities laws."

"The SEC asks this Court to take judicial notice of the "more than seventy cases" referenced in Appendix 1 of the report, which Cornerstone characterizes as "Cryptocurrency Enforcement Actions" — almost all of which the SEC never cited in its opening brief."

"In any event, the SEC has mischaracterized the prior enforcement actions. If the Court were to consider the cases cited in the report, they support Ripple's point that the enforcement action brought against it is unprecedented", the document stated.

Attorney Jeremy Hogan, a lawyer siding with Ripple in this lawsuit, summed up the situation: "The SEC wants to argue that the 75 actions/lawsuits it brought against crypto companies the last 5-6 years somehow put Ripple on notice that XRP was a security.

"Very misleading. The Telegram, Kik, Paragon cases all involved an ICO in which sales were made to CREATE the ledger", he said on Twitter.

"Ripple never held an ICO because the XRP ledger was ALREADY in existence when Ripple was formed. So, prior lawsuits against companies that held ICOs do NOT tend to show that Ripple had Fair Notice that what it was doing was illegal. Ripple is making an important distinction here", he continued.

Yesterday, the SEC fought back and responded to the defendant's SurReply saying Ripple Labs' argument is based on an incorrect characterization of the "fair notice" defense.

"Fair notice does not require such exact factual correspondence, and Ripple cites no case that suggests anything to the contrary", the SEC stated, further citing a recent ruling (United States v. Zaslavskyi) rejecting criminal defendant's contention that "the United States securities laws are unconstitutionally vague as applied to cryptocurrencies.

"Rather, the 'abundance of caselaw interpreting and applying at all levels of judiciary, as well as related guidance issued by the SEC as to the scope of its regulatory authority and enforcement power, provide all the notice that is constitutionally required'".

The SEC argued that giving in to the defendant's fair notice argument would nullify the Howie Test and its progeny's "flexible rather than…static principle" if a "fair notice defense can defeat any claim involving an investment product that is not identical to one previously deemed a security.

The Fair Notice affirmative defense is Ripple's most important argument against the SEC's accusations. The firm has called for a summary judgment on that defense. Attorney Jeremy Hogan has recently stated that if Ripple wins such judgment, the precedent "could save the industry from the SEC".

The lawsuit between the SEC and Ripple is most likely ending in a pre-trial settlement. 96% of all SEC cases are settled before trial, of which 60% before litigation and 90% in discovery. Mr. Hogan has recently presented his view on what a settlement may look like. One of the main points is that it could bottleneck the flow of XRP.

Anyway, Ripple may still lose the lawsuit. CEO Brad Garlinghouse told CNN the firm is ready to march on without the XRP if it loses the legal battle against the US regulator.

In the meantime, the world keeps dealing with the emergency of the cryptocurrency ecosystem. El Salvador has just approved Bitcoin as legal tender, with unforeseen consequences.

In the United States, however, the American Bankers Association has just warned the Senate against central bank digital currencies, a much desired market for Ripple.

ABA said CBDC proponents take a "highlight reel" approach to describing CBDC, "cherry-picking all the perceived benefits, while downplaying the serious risks to consumers and our financial system."

READ THIS NEXT

DIGITAL ASSETS

MYETHERWALLET (MEW) INTEGRATES WITH BINANCE SMART CHAIN

In a significant development, MyEtherWallet (MEW) has announced the launch of a bridge that would help the users of the MEW wallet to move their funds to Binance Smart Chain

INSIDE VIEW

WHAT ARE THE WORKING MECHANISMS OF LIQUIDITY PROVIDERS?

When you are going to get your feet wet to the Forex market, liquidity is among the basic notions you need to dive into

DIGITAL ASSETS, INDUSTRY NEWS

RIPPLE'S XRP, WHAT ABOUT NOW? SWIFT ANNOUNCES CROSS-BORDER PAYMENTS IN SECONDS

In 2019, SWIFT improved speeds to an average of 30 minutes for half of gpi payments with almost every transaction being completed in less than 24 hours. At

DIGITAL ASSETS

ETORO RELEASES REPORT ANALYZING TOP 100 YOUTUBE INFLUENCERS, MICHAEL SAYLOR AND ELON MUSK

The True Value of Influence analyzes the Top 100 Youtube influencers, as well as Elon Musk and Michael Saylor, in times of social trading.

INDUSTRY NEWS

FINTECH STARTUP NIUM RAISES $200 MILLION IN SERIES D FUNDING

Nium, a fintech startup based out of Singapore, has announced that it has raised $200 million in Series D funding that was led by Menlo Park and Riverwood Capital LLC.

INDUSTRY NEWS

EX-CITADEL SECURITIES NICOLA WHITE JOINS CRYPTO COUNTERPARTY B2C2 TO HEAD US OPERATION

The firm offers an entry point for financial institutions seeking to trade crypto with a reliable counterparty. Its client base includes banks, brokerages, exchanges, and fund

INDUSTRY NEWS

FRANCE AGREES TO SUBSTITUTED COMPLIANCE WITH SEC'S CAPITAL AND MARGIN REQUIREMENTS

The Securities and Exchange Commission under Chair Gary Gensler is tying up some loose ends of the Dodd-Frank Act.

INDUSTRY NEWS

GOLDMAN SACHS AND FISERV TIE UP TO BOOST TRANSACTION BANKING

Goldman Sachs has announced a tie-up with Fiserv to scale up its transaction banking business which was launched in the UK recently and has been gaining some good

DIGITAL ASSETS

BITCOIN DROPS BELOW $36K AS AMAZON DENIES IT WILL ACCEPT CRYPTO PAYMENT

Bitcoin bounced back from a six-week high it hit Monday morning after Amazon.com Inc denied a City A.M.'s report saying it will accept Bitcoin and even going as far as to

+ 44 7780 065864
info@financefeeds.com

Tab 19 – SEC v. Ripple Labs Podcast

Please click on the following link to access the podcast:

https://fedsoc.org/events/sec-v-ripple-labs-cryptocurrency-and-regulation-by-enforcement

New York Codes, Rules and Regulations
Title 23 - Financial Services
Chapter I - Regulations of the Superintendent of Financial Services
Part 200 - Virtual Currencies
200.2 - Definitions.

Universal Citation: 23 NY Comp Codes Rules and Regs § 200.2

23 CRR-NY 200.2

23 CRR-NY 200.2

200.2 Definitions.

For purposes of this Part only, the following definitions shall apply:

(a) *affiliate* means any person that directly or indirectly controls, is controlled by, or is under common control with, another person;

(b) *cyber security event* means any act or attempt, successful or unsuccessful, to gain unauthorized access to, disrupt, or misuse a licensee's electronic systems or information stored on such systems;

(c) *department* means the New York State Department of Financial Services;

(d) *exchange service* means the conversion or exchange of fiat currency or other value into virtual currency, the conversion or exchange of virtual currency into fiat currency or other value, or the conversion or exchange of one form of virtual currency into another form of virtual currency;

(e) *fiat currency* means government-issued currency that is designated as legal tender in its country of issuance through government decree, regulation, or law;

(f) *licensee* means any person duly licensed by the superintendent pursuant to this Part;

(g) *New York* means the State of New York;

(h) *New York resident* means any person that resides, is located, has a place of business, or is conducting business in New York;

(i) *person* means an individual, partnership, corporation, association, joint stock association, trust, or other entity, however organized;

(j) *prepaid card* means an electronic payment device that:

(1) is usable at a single merchant or an affiliated group of merchants that share the same name, mark, or logo, or is usable at multiple, unaffiliated merchants or service providers;

(2) is issued in and for a specified amount of fiat currency;

(3) can be reloaded in and for only fiat currency, if at all;

(4) is issued and/or reloaded on a prepaid basis for the future purchase or delivery of goods or services;

(5) is honored upon presentation; and

(6) can be redeemed in and for only fiat currency, if at all;

(k) *principal officer* means an executive officer of an entity, including, but not limited to, the chief executive, financial, operating, and compliance officers, president, general counsel, managing partner, general partner, controlling partner, and trustee, as applicable;

(l) *principal stockholder* means any person that directly or indirectly owns, controls, or holds with power to vote 10 percent or more of any class of outstanding capital stock or other equity interest of an entity or possesses the power to direct or cause the direction of the management or policies of the entity;

(m) *principal beneficiary* means any person entitled to 10 percent or more of the benefits of a trust;

(n) *qualified custodian* means a bank, trust company, national bank, savings bank, savings and loan association, Federal savings association, credit union, or Federal credit union in the State of New York, subject to the prior approval of the superintendent. To the extent applicable, terms used in this definition shall have the meaning ascribed by the Banking Law;

(o) *transmission* means the transfer, by or through a third party, of virtual currency from a person to a person, including the transfer from the account or storage repository of a person to the account or storage repository of a person;

(p) *virtual currency* means any type of digital unit that is used as a medium of exchange or a form of digitally stored value. virtual currency shall be broadly construed to include digital units of exchange that: have a centralized repository or administrator; are decentralized and have no centralized repository or administrator; or may be created or obtained by computing or manufacturing effort. *Virtual currency* shall not be construed to include any of the following:

(1) digital units that:

(i) are used solely within online gaming platforms;

(ii) have no market or application outside of those gaming platforms;

(iii) cannot be converted into, or redeemed for, fiat currency or virtual currency; and

(iv) may or may not be redeemable for real-world goods, services, discounts, or purchases;

(2) digital units that can be redeemed for goods, services, discounts, or purchases as part of a customer affinity or rewards program with the issuer and/or other designated merchants or can be redeemed for digital units in another customer affinity or rewards program, but cannot be converted into, or redeemed for, fiat currency or virtual currency; or

(3) digital units used as part of prepaid cards;

(q) *virtual currency business activity* means the conduct of any one of the following types of activities involving New York or a New York resident:

(1) receiving virtual currency for transmission or transmitting virtual currency, except where the transaction is undertaken for non-financial purposes and does not involve the transfer of more than a nominal amount of virtual currency;

(2) storing, holding, or maintaining custody or control of virtual currency on behalf of others;

(3) buying and selling virtual currency as a customer business;

(4) performing exchange services as a customer business; or

(5) controlling, administering, or issuing a virtual currency.

The development and dissemination of software in and of itself does not constitute virtual currency business activity.

23 CRR-NY 200.2

Current through April 30, 2020

NY Virtual Currency Business Activity License New Application Checklist (Company)

CHECKLIST SECTIONS

GENERAL INFORMATION

Who Is Required to Have This License?

The license requirements for Virtual Currency Business Activity are found primarily in 23 NYCRR Part 200. 23 NYCRR 200.3(a) provides, in part:

> *"No Person shall, without a license obtained from the superintendent …, engage in any Virtual Currency Business Activity."*

Also, 23 NYCRR 200.2(q) provides, in part:

> *"Virtual Currency Business Activity means the conduct of any one of the following types of activities involving New York or a New York Resident:*
> *(1) receiving Virtual Currency for Transmission or Transmitting Virtual Currency, except where the transaction is undertaken for non-financial purposes and does not involve the transfer of more than a nominal amount of Virtual Currency;*
> *(2) storing, holding, or maintaining custody or control of Virtual Currency on behalf of others;*
> *(3) buying and selling Virtual Currency as a customer business;*
> *(4) performing Exchange Services as a customer business; or*
> *(5) controlling, administering or issuing a Virtual Currency."*

In addition to the items listed in the checklist below, the New York State Department of Financial Services (NY-DFS) may require, as it deems necessary, the submission of any other information or documentation. *See, e.g.,* 23 NYCRR 200.4(a)(15).

Please fill in all sections of the NMLS application that are relevant to the applicant—including the Company Form (MU1) and Individual Forms (MU2) for all relevant individuals as provided below. The checklist below clarifies the items required by NY-DFS for certain parts of the NMLS application. It does not waive any parts of the NMLS application unless the checklist expressly states that those parts of the NMLS application need not be filled out.

Activities Authorized Under This License

This license authorizes the following activities:

- Virtual currency exchanging and trading services
- Electronic money transmitting*
- Issuing prepaid access/stored value*
- Selling prepaid access/stored value*

*These NMLS business activities also encompass virtual currency. Conducting this activity with a virtual currency requires an approved NY Virtual Currency Business Activity License. Conducting this activity with a fiat currency requires an approved NY Money Transmitter License. See the NY Money Transmitter License New Application Checklist for more information.

NY-DFS does issue paper licenses for this license type.

Document Uploads Guidance

Documents that must be uploaded to the *Document Uploads* section of the Company Form (MU1) in NMLS are indicated in the checklist below. When uploading documents:

- Follow the guidance in Document Upload Descriptions and Examples.
- Only upload documents relevant to the company application.
- Only upload documents where there is a selectable document category. If inappropriate documents are uploaded that should not be, you will be contacted by your regulator and asked to remove them from NMLS.
- Do not upload the same company documents multiple times. Generally, unless the document is state-specific, if the document has already been uploaded for another state, a new upload is not required unless changes have been made.
- If a document previously uploaded has been revised, delete the old document and replace it with the new document (history of the old document will remain in NMLS).
- For state-specific documents (e.g., Surety Bonds), be sure to indicate the applicable state.

Helpful Resources

- Company Form (MU1) Filing Instructions
- Document Upload Descriptions and Examples
- Individual Form (MU2) Filing Quick Guide
- Financial Statements Quick Guide
- Payment Options Quick Guide
- License Status Definitions Quick Guide

Agency Contact Information

Contact NY-DFS licensing staff by phone at (212) 709-3812 or by email at VCLicenseQuestions@dfs.ny.gov.

For U.S. Postal Service & Overnight Delivery:
New York State Department of Financial Services
Research and Innovation Division
One State Street
New York, NY 10004-1511

THE APPLICANT/LICENSEE IS FULLY RESPONSIBLE FOR ALL OF THE REQUIREMENTS OF THE LICENSE FOR WHICH THEY ARE APPLYING. THE AGENCY SPECIFIC REQUIREMENTS CONTAINED HEREIN ARE FOR GUIDANCE ONLY TO FACILITATE APPLICATION THROUGH NMLS. SHOULD YOU HAVE QUESTIONS, PLEASE CONSULT LEGAL COUNSEL.

LICENSE FEES - *Fees collected through NMLS are NOT REFUNDABLE OR TRANSFERABLE.*		
Complete	**NY Virtual Currency Business Activity License**	**Submitted via . . .**
☐	**NY-DFS Application Fee:** $5,000 **NMLS Initial Processing Fee:** $0	**NMLS (Filing submission)**
☐	**Credit Report for Control Persons:** $15 per control person.	**NMLS (Filing submission)**

REQUIREMENTS COMPLETED IN NMLS		
Complete	**NY Virtual Currency Business Activity License**	**Submitted via . . .**
☐	**Submission of Company Form (MU1):** Complete and submit the Company Form (MU1) in NMLS. This form serves as the application for the license/registration through NMLS.	**NMLS**
☐	**Financial Statements:** Upload the applicant's audited financial statements for the two most recent fiscal years, prepared by a Certified Public Accountant in accordance with Generally Accepted Accounting Principles. Audited financial statements should include a balance sheet, income statement, and statement of cash flows and all relevant notes thereto. Generally, if the applicant is a start-up company, only an initial statement of condition is required. *If audited financial statements are unavailable, provide unaudited statements signed by an authorized officer and include an explanation of why audited financial statements are unavailable.* **Note:** Financial statements are uploaded separately under the Filing tab and *Financial Statement* submenu link. See the Financial Statements Quick Guide for instructions.	**NMLS**

☐	**Other Trade Name:** If operating under a name that is different from the applicant's legal name, that name ("Trade Name," "Assumed Name," or "DBA") must be listed under the *Other Trade Names* section of the Company Form (MU1). NY-DFS does not limit the number of Other Trade Names. If operating under an Other Trade Name, upload documentation regarding the ability to do business under that trade name. This document should be named *NY Virtual Currency Business Activity Trade Name – Assumed Name*. **Note:** Corporations, limited liability companies, and limited partnerships proposing to conduct business under an assumed name (e.g., DBA) must apply to the Secretary of State for authorization to do so. Individuals, general partnerships, and limited liability partnerships proposing to conduct business under an assumed name must apply to the County Clerk of each county in which the business will operate for permission to do so. In either case, certified copies of the applicable authorization must be submitted to NY-DFS. See also the Restricted Words item below.	**NMLS** **Upload in NMLS:** under the Document Type Trade Name/Assumed Name Registration Certificates in the *Document Uploads* section of the Company Form (MU1).
☐	**Resident/Registered Agent:** The Resident/Registered Agent must be listed under the *Resident/Registered Agent* section of the Company Form (MU1). **Note:** The Resident/Registered Agent is the entity that will receive service of legal process on behalf of the applicant in the state identified.	**NMLS**
☐	**Primary Contact Employees:** The following individuals must be entered into the *Contact Employees* section of the Company Form (MU1). 1. Primary Company Contact. 2. Primary Consumer Complaint Contact.	**NMLS**
☐	**Non-Primary Contact Employees:** NY-DFS requires that an individual(s) be identified as a Non-Primary Contact for the following areas. These contacts must be listed in the *Contact Employees* section of the Company Form (MU1). 1. Accounting 2. Licensing 3. Consumer Complaint (Public) 4. Consumer Complaint (Regulator) 5. Legal 6. Pre-Exam Contact	**NMLS**
☐	**Approvals and Designations:** Enter the Company's FinCEN Registration—Confirmation Number and Filing Date—in the *Approvals and Designations* section of the Company Form (MU1).	**NMLS**

☐	**Bank Account:** The following bank account information must be completed in the *Bank Account* section of the Company Form (MU1). • Identify bank(s) the applicant will use for purposes of Virtual Currency Business Activity, both foreign and domestic. • Identify banks(s) that will extend credit to the applicant.	**NMLS**
☐	**Disclosure Questions:** Provide a complete and detailed explanation and document upload for each "Yes" response to Disclosure Questions made by the company or related control persons (MU2). See the Company Disclosure Explanations Quick Guide for instructions.	**Upload in NMLS:** under the *Disclosure Explanations* section of the Company Form (MU1) or Individual Form (MU2).

☐	**Direct Owners and Executive Officers:** The following individuals and entities must be identified in the *Direct Owners and Executive Officers* section of the Company Form (MU1):
	• For both the *applicant* and the *applicant's immediate parent company(-ies)* (exclusive of non-operating holding companies):
	  • All directors (or equivalent members of a governing body);
	  • All executive officers, including, as applicable,
	    • the chief executive, financial, operating, information security, and compliance officers*; and
	    • the president, general counsel, managing partner, general partner, controlling partner, and trustee.
	• For the *applicant*:
	  • Any individual or entity that *directly*
	    • owns, controls, or holds with power to vote 10% or more of any class of outstanding capital stock or other equity interest of the applicant; or
	    • possesses the power to direct or cause the direction of the management or policies of the applicant; and,
	  • The BSA/AML officer, if different from the chief compliance officer.
	***Chief Compliance Officer Note:** The applicant's chief compliance officer (and the AML/BSA officer if different) must have a minimum of three years' experience in performing compliance (or, in the case of an AML/BSA officer, performing AML/BSA compliance) for a money transmitter, bank, or virtual currency business, consistent with the proposed activities of the applicant. The applicant's chief compliance officer (and the AML/BSA officer if different) must also demonstrate that he or she has undertaken acceptable, current training on topics directly related to the activities and business of the applicant and his or her function as a compliance (or AML/BSA) officer.*
	Note: Individuals identified in the *Direct Owners and Executive Officers* section of the Company Form (MU1) are required to complete and submit an Individual Form (MU2) along with the Company Form (MU1). See the Individual Form (MU2) Filing Quick Guide for more information.
		NMLS

☐	**Indirect Owners:** Individuals and entities identified in the *Indirect Owners* section of the Company Form (MU1) must include:
	• Any individual or entity not identified in the *Direct Owners and Executive Officers* section that *indirectly*
	  • owns, controls, or holds with power to vote 10% or more of any class of outstanding capital stock or other equity interest of the applicant; or
	  • possesses the power to direct or cause the direction of the management or policies of the applicant.
	Note: Individuals identified in the *Indirect Owners* section of the Company Form (MU1) are required to complete and submit an Individual Form (MU2) along with the Company Form (MU1). See the Individual Form (MU2) Filing Quick Guide for more information.
		NMLS

Note	**Qualifying Individual:** The *Qualifying Individual* section is not, in all cases, required to be completed for NY-DFS on the Company Form (MU1). **Note:** Based on NY-DFS's review of the documents uploaded in the Ownership Itemization and Organizational Chart/Description items described below, NY-DFS often requires the *Qualifying Individual* section to be completed for any individuals identified by NY-DFS who were not listed as Direct Owners and Executive Officers or Indirect Owners but for whom additional information is required. Individual Forms (MU2) must be submitted for these Qualifying Individuals. Please note that NY-DFS's identification of Qualifying Individuals can be fairly inclusive. For example, NY-DFS may identify an individual as a Qualifying Individual due to an ownership interest that is several steps above the applicant in the corporate family tree. **Note:** The above use of the term "Qualifying Individual" on the Company Form (MU1) may not correspond to its use in other NMLS application processes.	**NMLS:** only if Qualifying Individuals are required by NY-DFS for the applicant. **Note:** If submission of an Individual Form (MU2) is impracticable for any Qualifying Individual, please arrange with NY-DFS for submission of the equivalent information outside of NMLS, by a method approved in writing by NY-DFS.
☐	**Control Person (MU2) Attestation:** Complete the Individual Form (MU2) in NMLS. This form must be attested to by the applicable control person before it is able to be submitted along with the Company Form (MU1).	**NMLS**
☐	**Credit Report:** Each individual required to submit an Individual Form (MU2) must authorize a credit report through NMLS. Individuals will be required to complete an Identity Verification Process (IDV) along with an individual attestation before a license request for your company can be filed through NMLS. This authorization is made when the Individual Form (MU2) is submitted as part of the Company Form (MU1).	**NMLS**

Note	**MU2 Individual FBI Criminal Background Check Not Required Through NMLS:** Direct Owners/Executive Officers, Indirect Owners, and Qualifying Individuals are NOT required to authorize an FBI criminal background check (CBC) through NMLS. **Note:** See the Requirements/Documents Uploaded in NMLS or Requirements Completed Outside of NMLS section for CBC requirements.	**N/A**

REQUIREMENTS/DOCUMENTS UPLOADED IN NMLS		
Complete	**NY Virtual Currency Business Activity License**	**Submitted via . . .**
☐	**AML/BSA Policy:** Upload the following items related to the applicant's Anti-Money Laundering/Bank Secrecy Act Policy ("AML/BSA Policy"): • Applicant's most recent AML/BSA Policy; • Implementing procedures; • Associated risk assessment; • The risk assessment's associated methodology; and • The most recent Independent Review of the AML/BSA Program. In addition, please identify the individual or individuals who will be responsible for coordinating and monitoring day-to-day compliance with the applicant's AML/BSA Program and (if not provided elsewhere) provide background information and materials demonstrating that the identified individual(s) is qualified to carry out such functions. **Note:** For AML/BSA Policies, and *for all other policies uploaded under the "Company Staffing and Internal Policies"* item below that relate to risk mitigation, the applicant should upload (i) a risk-assessment methodology, (ii) a risk assessment, (iii) a policy, and (iv) implementing procedures. For reference, the risk-assessment methodology should include the metrics used to evaluate the risks identified in the risk assessment. The risk assessment should identify risks based on the applicant's specific business activities. Each policy should be risk-based and should include measures designed to mitigate the risks identified by the related risk assessment. Finally, the procedures should describe how the objectives identified in the policy will be achieved in the day-to-day operations of the organization. 23 NYCRR 200.15 addresses the AML/BSA requirements for Virtual Currency Business Activity applicants. This document should be named *AML-BSA Policy and Materials [approval date mm-dd-yyyy].*	**Upload in NMLS:** under the Document Type AML/BSA Policy in the *Document Uploads* section of the Company Form (MU1).

☐	**Business Plan:** Upload a business plan with detailed information in the following areas: • Detailed biographical information for each of the individuals identified in the *Direct Owners and Executive Officers* section of the Company Form (MU1) who is involved in the day-to-day management of the applicant or its regulatory or compliance functions. • Detailed descriptions of the applicant's proposed, current, and historical business, including (i) all products and services; (ii) the domestic and foreign jurisdictions in which the applicant is engaging or has engaged in business (including dates) or plans to be engaged in business; (iii) the applicant's principal place of business; (iv) the applicant's target customers and any specific marketing targets; and (v) any physical addresses of operation in New York State. • A schedule of the fees to be charged by the applicant, and an equivalent description of any other revenue sources. • An explanation of the methodologies the applicant uses to calculate the value of virtual currency in terms of fiat currency and vice versa, and to calculate the value of one virtual currency in terms of another; or, if not applicable, a detailed explanation as to why. ("Fiat currency" refers to national currencies such as the U.S. dollar, the Euro, or the Japanese Yen.) • If applicable, copies of all insurance policies maintained for the benefit of the applicant, its directors or officers, and its customers. • A discussion of third-party service providers (including affiliates) that provide services to the applicant relevant to its Virtual Currency Business Activity. • A detailed description of virtual currency custodianship, including the wallet structure in use by the applicant and/or its customers, and including, as relevant, the use of and percentages stored in hot/cold wallets.(*) • A detailed description of how the applicant uses blockchain and/or internal ledgers to facilitate transactions. • Domestic and international jurisdictions in which the applicant, or any parent, affiliate, or subsidiary, is licensed, or is otherwise authorized to engage in virtual currency, money transmission, or other financial services activity, or has applied for such authorization, and the amount of any bond or deposit furnished in each such jurisdiction. In each case, please also specify the type of activity for which the applicant is licensed or otherwise authorized. The uploaded business plan should also include the following: • Projected balance sheets and income statements for the applicant's current fiscal year and subsequent two fiscal years of operation, for both the applicant's business overall and its planned business involving New York or New York Residents. For the planned business involving New York or New York Residents, projections should include the expected quarterly receipts and	**Upload in NMLS:** under the Document Type <u>Business Plan</u> in the *Document Uploads* section of the Company Form (MU1).

	expected number of transactions. (Projected financial statements should include the assumptions used in making the projections. Any projected losses should be explained and an estimate of time to achieve profitability should be given.) • *If applicable*, audited financial statements, for the two most recent fiscal years, for the applicant's *immediate controlling* parent company, not including non-operating holding companies. (If audited financial statements are unavailable for the two most recent fiscal years, the applicant's parent should provide unaudited financial statements signed by an authorized officer and accompanied by an explanation of why audited financial statements are unavailable.) (*) For purposes of this item, "cold wallet" refers to an offline system for storing the private keys associated with virtual currency that has never been connected, directly or indirectly, to the public Internet; and "hot wallet" refers to a system for storing the private keys associated with virtual currency that is or has been connected, directly or indirectly, to the public Internet. This document should be named *[Company Legal Name] Business Plan*. **Note:** If the existing uploaded business plan already includes the above information, an additional document does not need to be uploaded. A company should only upload a single business plan. If state-specific material is required, this information should be added to the existing uploaded business plan.	
☐	**Certificate of Authority/Good Standing Certificate:** Upload a State-issued and approved document (typically by the Secretary of State's office), dated not more than 60 days prior to the filing of the application through NMLS, that demonstrates authorization to do business in the applicant's state of formation and New York. This document(s) should be named *[State prefix] Certificate of Authority OR [State prefix] Certificate of Good Standing.*	**Upload in NMLS:** under the Document Type Certificate of Authority/Good Standing Certificate in the *Document Uploads* section of the Company Form (MU1).

☐	**Company Staffing and Internal Policies:** Upload document(s) including information on staffing and internal organizational policies and procedures. For all policies uploaded under the Company Staffing and Internal Policies item that relate to risk mitigation, the applicant should upload (i) a risk-assessment methodology, (ii) a risk assessment, (iii) a policy, and (iv) implementing procedures. See the "Note" portion of the entry *AML/BSA Policy*, above, for an ***important*** discussion of the content required in such policies, procedures, risk assessments, and risk-assessment methodologies. (The policies and procedures in a given area are often combined into a single document, but they need not be.) The uploaded documents should include: • Privacy and Information Security Policy, Procedures, and related Risk Assessment. (Note: These are often incorporated into the Cybersecurity Policy, Procedures, and related Risk Assessment.) • Cybersecurity Policy, Procedures, and related Risk Assessment, along with the most recent Independent Review of the Cybersecurity Program. • Third-Party Service Provider Management and Onboarding Policy and Procedures. Please ensure this policy includes (i) a list of all third parties to be engaged by the applicant; (ii) a description of the services to be provided by the third parties; and (iii) a description of the due diligence performed on all third parties prior to engagement. • Business Continuity and Disaster Recovery Policy, Procedures, and related Risk Assessment. • Consumer Protection Policy and Procedures, and related sample documents (see Document Samples item below). • Anti-Fraud Policy, Procedures, and related Risk Assessment. • Complaints Policy and Procedures. • Any other policies, procedures, risk assessments and/or risk-assessment methodologies that are relevant to the applicant's proposed Virtual Currency Business Activity. The uploaded documents should also include: • All service-level agreements entered into with third-party service providers whose services relate to the applicant's Virtual Currency Business Activity or related compliance obligations. • Copies of any agreements not uploaded elsewhere that the applicant has entered into (or will enter into) in anticipation of Virtual Currency Business Activity. These documents should be named *[Name of Document].*	**Upload in NMLS:** under the Document Type Company Staffing and Internal Policies in the *Document Uploads* section of the Company Form (MU1).

☐	**Ownership Itemization:** In addition to the Organizational Chart and various Company Staffing and Internal Policies, an applicant must provide an Ownership Itemization including: • A list of all individuals having any ownership interest in the applicant, showing the percentage ownership of each individual; • A list of all individuals having any ownership interest in any entity with a direct or indirect ownership interest in the applicant, broken down by the entity in which the interest is held, and showing the percentage ownership of each individual in each entity; • For any applicant that is a trust, a list of all individuals entitled to 10% or more of the benefits of the trust, showing the percentage applying to each such individual. **Note:** For publicly held entities, the Ownership Itemization may require the production of a spreadsheet or database report. NY-DFS may modify this requirement, at NY-DFS's discretion, in cases where the necessary information can be provided in a more convenient way. To be valid, any such modification by NY-DFS must be in writing. This document should be named *Ownership Itemization*.	**Upload in NMLS:** under the Document Type Company Staffing and Internal Policies in the *Document Uploads* section of the Company Form (MU1).
☐	**Document Samples:** Upload copies of the following sample documents the applicant plans to issue or use with customers in this state: • Customer disclosures and agreements; and • Receipts, customer confirmations, and any similar instruments. These documents should be named *[Name of Document Sample].*	**Upload in NMLS:** under the Document Type Document Samples in the *Document Uploads* section of the Company Form (MU1).
☐	**Flow of Funds Structure:** Submit a description of each type of transaction or service to be conducted. For each type, describe each step starting with the first encounter with the consumer or other customer and ending at the completion of the transaction or service. For each type of transaction or service, also include one or more detailed flow of funds diagram(s), showing all flows of funds, including virtual and fiat currency, that will occur in the applicant's normal operations. Specify who directs the flow and how it is done; the name and address of each entity the funds flow through; the title of each account; ownership or control of the accounts and addresses; and who or what entity is liable for the funds at all points. This document should be named *Flow of Funds Structure*. **Note:** If submitting multiple types of transactions or services to be conducted, combine in single document for upload.	**Upload in NMLS:** under the Document Type Flow of Funds Structure in the *Document Uploads* section of the Company Form (MU1).

☐	**Formation Document:** Determine classification of applicant's legal status and submit a State certified copy of the requested applicable documentation detailed below. Submit copies of the original formation documents and all subsequent amendments thereto, including a list of any name changes.
	Sole Proprietor:
	• NY-DFS will request additional documentation for sole proprietors on a case by case basis.
	Unincorporated Association:
	• By-Laws or constitution (including all amendments).
	General Partnership:
	• Partnership Agreement (including all amendments).
	Limited Liability Partnership:
	• Certificate of Limited Liability Partnership; and
	• Partnership Agreement (including all amendments).
	Limited Partnership:
	• Certificate of Limited Partnership; and
	• Partnership Agreement (including all amendments).
	Limited Liability Limited Partnership:
	• Certificate of Limited Liability Limited Partnership; and
	• Partnership Agreement (including all amendments).
	Limited Liability Company ("LLC"):
	• Articles of Organization (including all amendments);
	• Operating Agreement (including all amendments);
	• IRS Form 2553 or IRS Form 8832 if S-corp treatment elected; and
	• LLC resolution if authority not in operating agreement.
	Corporation:
	• Articles of Incorporation (including all amendments);
	• By-laws (including all amendments), if applicable;
	• Shareholder Agreement (including all amendments), if applicable;
	• IRS Form 2553 if S-corp treatment elected; and
	• Corporate resolution if authority to complete application not in By-Laws or Shareholder Agreement, as amended, as applicable.
	Not-for-Profit Corporation:
	• Documents requested of a Corporation; and
	• Proof of nonprofit status
	    o Internal Revenue Service ("IRS") 501(c)(3) designation letter; or
	    o Statement from a State taxing body or the State attorney general certifying that: (i) the entity is a nonprofit organization operating within the State; and (ii) no part of the entity's net earnings may lawfully benefit any private shareholder or individual; or
		Upload in NMLS: under the Document Type <u>Formation Document</u> in the *Document Uploads* section of the Company Form (MU1).

	○ Entity's certificate of incorporation or similar document if it clearly establishes the nonprofit status of the applicant; or ○ Any of the three preceding items described, if that item applies to a State or national parent organization, together with a statement by the State or parent organization that the applicant is a local nonprofit affiliate. **Trust (Statutory):** • Certificate of Trust; and • Governing instrument (all amendments). This document should be named *Formation Documentation [Date of Creation (MM-DD-YYYY)].*	
☐	**Management Chart:** Submit a management chart displaying the applicant's directors, officers, and managers (individual name and title). Must also identify all front office business units and back office reporting for compliance, internal audit, and IT infrastructure. This document should be named *[Company Legal Name] Management Chart*. **Note:** If the existing uploaded management chart already includes the above information, an additional document does not need to be uploaded. A company should only upload a single management chart.	**Upload in NMLS:** under the Document Type Management Chart in the *Document Uploads* section of the Company Form (MU1).
☐	**Organizational Chart/Description:** Submit a chart showing the percentage of ownership of: • Direct Owners (total direct ownership percentage must equate to 100%); • Indirect Owners; • Parents, affiliates, and subsidiaries of the applicant/licensee; and • All 10% or greater owners. This document should be named *[Company Legal Name] Organizational Chart-Description.* **Note:** If the existing uploaded Organizational Chart/Description already includes the above information, an additional document does not need to be uploaded. A company should only upload a single Organizational Chart/Description.	**Upload in NMLS:** under the Document Type Organizational Chart/Description in the *Document Uploads* section of the Company Form (MU1).

☐	**Surety Bond OR Trust Account Authorization:** Each licensee shall maintain a surety bond or trust account in United States dollars for the benefit of its customers in such form and amount as is acceptable to the Superintendent for the protection of the licensee's customers. Upload and mail documentation showing compliance in the form found at Virtual Currency Licensee Bond Requirement, or proof of establishment of a trust account. Unless otherwise specified by NY-DFS, the current NY-DFS requirement for the surety bond or trust account is $500,000 for each Virtual Currency Business Activity License. Surety bond document(s) should be named *[Company Legal Name] Surety Bond.* ***OR*** Trust Account document(s) should be named *[Company Legal Name] Trust Account.* **Note:** If the applicant intends to use a trust account for the protection of customer funds the applicant must submit authorization allowing examination of trust accounts used for the purpose of holding funds belonging to others at the time such trust accounts are opened. Such authorizations may require multiple documents when more than one account exists. Upload each authorization separately. No license will be issued without proof that the applicant has obtained a surety bond or trust account acceptable to the Superintendent.	**Upload in NMLS:** under the Document Type Surety Bond in the *Document Uploads* section of the Company Form (MU1). **OR** **Upload in NMLS:** under the Document Type Trust Account Authorization in the *Document Uploads* section of the Company Form (MU1). **Note:** This item must also be mailed to: **NY-DFS** Attn: Research and Innovation Division One State Street New York, NY 10004
INDIVIDUAL (MU2) DOCUMENTS UPLOADED IN NMLS		
☐	**Credit Report Explanations:** Submit a line by line, detailed letter of explanation of all derogatory credit accounts along with proof of payoffs, payment arrangements and evidence of payments made, or evidence of any formal dispute filed (documents must be dated). Accounts to address include, but are not limited to: collections items, charge offs, accounts currently past due, accounts with serious delinquencies in the last 3 years, repossessions, loan modifications, etc. **Note:** Items regarding bankruptcy, foreclosure actions, outstanding judgments or liens, or delinquent child support payments should be addressed in the *Disclosure Explanations* section of your Individual Form (MU2). This document should be named *Credit Report Explanations – [Subject Name] – [Document Creation Date].*	**Upload in NMLS:** under the Document Type Credit Report Explanations in the *Document Uploads* section of the Individual Form (MU2).

☐	**Photo Identification:** Upload an individual, government-issued photographic identification, such as a valid state driver license, state photo identification, or passport.	**Upload in NMLS:** under the Document Type Legal Name/Status Documentation in the *Document Uploads* section of the Individual Form (MU2).
☐	**Personal Financial Statement:** Individuals identified as Direct Owners and Executive Officers, individuals listed as Indirect Owners, and individuals NY-DFS requires to be listed as Qualifying Individuals are required to upload a personal financial statement. See here to access the NY-DFS Financial Statement Form. This document should be named *NY – Personal Financial Statement.*	**Upload in NMLS:** under the Document Type Personal Financial Statement in the *Document Uploads* section of the Individual Form (MU2).
☐	**Authority to Release Information:** Individuals identified as Direct Owners and Executive Officers, individuals listed as Indirect Owners, and individuals NY-DFS requires to be listed as Qualifying Individuals must submit the Authority to Release Information Form. This document should be named *NY Authority to Release Information.*	**Upload in NMLS:** under the Document Type State Background Check Authorization in the *Document Uploads* section of the Individual Form (MU2).
☐	**Verification of Experience:** Upload a resume or curriculum vitae for each individual that provides an Individual Form (MU2). This document should be named *[Document Type] – License Name.*	**Upload in NMLS:** under the Document Type Verification of Experience in the *Document Uploads* section of the Individual Form (MU2).

NMLS ID Number	
Applicant Legal Name	

REQUIREMENTS SUBMITTED OUTSIDE OF NMLS		
Complete	**NY Virtual Currency Business Activity License**	**Submitted via . . .**
☐	**Surety Bond or Trust Account Authorization:** Submit the original bond or details of Trust Account Authorization as described above.	**Mail to NY-DFS** Attn: Research and Innovation Division

		One State Street New York, NY 10004
☐	**Restricted Words:** If the name of the applicant contains certain words, the approval of the Superintendent must be obtained. This applies to licensees as well as other non-licensed entities. The restricted words include, for example, "acceptance," "bank," "finance," "investment," "loan," "mortgage," "savings," "trust," and their derivatives. The process for approval for the use of any of these restricted words can be found here.	**Mail to NY-DFS** **Attn: Office of General Counsel, Name Approval** One State Street New York, NY 10004
☐	**Fingerprints for Control Persons:** Each individual for whom an Individual Form (MU2) is required to be filed must follow the Fingerprint Instructions posted on the NY-DFS website.	**Mail to NY-DFS** Attn: Research and Innovation Division One State Street New York, NY 10004
☐	**Information Regarding Persons Residing in Foreign Jurisdictions:** For each individual for whom an Individual Form (MU2) is required to be filed, if the individual does not reside in the U.S. or has not resided in the U.S. for the last 5 years, an investigation background report must be prepared by an acceptable search firm. This report must be directly sent from the firm to NY-DFS, and must include all items required by NY-DFS for third-party background checks, found at Required Background Investigation Information. **Note:** NY-DFS does not offer recommendations with respect to particular firms that provide background checks. Background reports may also be required for other officers, directors, stockholders, owners, and control persons of the applicant as determined by the Superintendent in her sole discretion. At minimum, the firm must demonstrate that it has sufficient resources and is properly licensed to conduct the research of the individual's background and that the firm is not affiliated with, or an interest of, any of the individuals under investigation. The cost of the report must be borne by the applicant or the individual. The background report must be in English and submitted directly to NY-DFS in addition to other background information required in the application. At minimum the report must contain the following: • A comprehensive credit report/history, including a search of the court data in the countries, states, and towns where the individual resided and worked and in contiguous areas; • Criminal records for the past 10 years, including felonies, misdemeanors and violations including a search of court data in the countries, states, and towns where the individual resided and worked and in contiguous areas; • Employment history; • Media history including an electronic search of national and local publications, wire services, and business	**Mail to NY-DFS** Attn: Research and Innovation Division One State Street New York, NY 10004

	publications; and • Regulatory history, particularly securities, insurance, mortgage-related, real estate, virtual-currency related, money transmission, etc., if applicable.	

Tab 22 – Grayscale Annual Report on Form 10-K

Please see the following link for the full Annual Report:

https://www.sec.gov/ix?doc=/Archives/edgar/data/0001588489/000156459021011121/gbtc-10k_20201231.htm

Tab 23 – Osprey Information Sheet

Please see the following link for the Osprey Information Sheet:

https://www.sec.gov/Archives/edgar/data/0001767057/000093041321001296/c101984_ex99-1.htm

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Kristina Littman
Preethi Krishnamurthy
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UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION,	:	
	:	
Plaintiff,	:	**20 Civ. 10832**
	:	
- against -	:	**ECF Case**
	:	
RIPPLE LABS, INC., BRADLEY GARLINGHOUSE, and CHRISTIAN A. LARSEN,	:	**Complaint** **Jury Trial Demanded**
	:	
Defendants.	:	
	:	

Plaintiff Securities and Exchange Commission (the "SEC"), for its Complaint against Defendants Ripple Labs, Inc. ("Ripple"), Bradley Garlinghouse ("Garlinghouse"), and Christian A. Larsen ("Larsen" and, with Ripple and Garlinghouse, "Defendants"), alleges as follows:

SUMMARY

1. From at least 2013 through the present, Defendants sold over 14.6 billion units of a digital asset security called "XRP," in return for cash or other consideration worth over $1.38 billion U.S. Dollars ("USD"), to fund Ripple's operations and enrich Larsen and Garlinghouse. Defendants undertook this distribution without registering their offers and sales of XRP with the SEC as required by the federal securities laws, and no exemption from this requirement applied.

2. Because Ripple never filed a registration statement, it never provided investors with the material information that every year hundreds of other issuers include in such statements when soliciting public investment. Instead, Ripple created an information vacuum such that Ripple and the two insiders with the most control over it—Larsen and Garlinghouse—could sell XRP into a market that possessed only the information Defendants chose to share about Ripple and XRP.

3. Ripple engaged in this illegal securities offering from 2013 to the present, even though Ripple received legal advice as early as 2012 that under certain circumstances XRP could be considered an "investment contract" and therefore a security under the federal securities laws.

4. Ripple and Larsen ignored this advice and instead elected to assume the risk of initiating a large-scale distribution of XRP without registration.

5. From a financial perspective, the strategy worked. Over a years-long unregistered offering of securities (the "Offering"), Ripple was able to raise at least $1.38 billion by selling XRP without providing the type of financial and managerial information typically provided in registration statements and subsequent periodic and current filings. Ripple used this money to fund its operations without disclosing how it was doing so, or the full extent of its payments to others to assist in its efforts to develop a "use" for XRP and maintain XRP secondary trading markets.

6. Meanwhile, Larsen—Ripple's initial chief executive officer ("CEO") and current chairman of the Board—and Garlinghouse—Ripple's current CEO—orchestrated these unlawful sales and personally profited by approximately $600 million from their unregistered sales of XRP.

7. Garlinghouse did so while repeatedly touting that he was "very long" XRP, meaning he held a significant position he expected to rise in value, without disclosing his sales of XRP.

8. Defendants continue to hold substantial amounts of XRP and—with no registration statement in effect—can continue to monetize their XRP while using the information asymmetry they created in the market for their own gain, creating substantial risk to investors.

VIOLATIONS

9. By engaging in the conduct set forth in this Complaint, Defendants engaged in and are currently engaging in the unlawful offer and sale of securities in violation of Sections 5(a) and 5(c) of the Securities Act of 1933 ("Securities Act") [15 U.S.C. §§ 77e(a) and 77e(c)], and Larsen and Garlinghouse also aided and abetted Ripple's violations of those provisions.

10. Unless Defendants are permanently restrained and enjoined, they will continue to engage in the acts, practices, and courses of business set forth in this Complaint and in acts, practices, and courses of business of similar type and object.

NATURE OF THE PROCEEDING AND RELIEF SOUGHT

11. The Commission brings this action pursuant to the authority conferred upon it by Section 20(b) of the Securities Act [15 U.S.C. § 77t(b)].

12. The Commission seeks a final judgment: (a) permanently enjoining Defendants from violating Sections 5(a) and 5(c) of the Securities Act, pursuant to Section 20(b) of the Securities Act [15 U.S.C. § 77t(b)]; (b) pursuant to Section 21(d)(5) of the Securities Exchange Act of 1934 ("Exchange Act"), (i) ordering Defendants to disgorge their ill-gotten gains and to pay prejudgment interest thereon and (ii) prohibiting Defendants from participating in any offering of digital asset securities; and (c) imposing civil money penalties on Defendants pursuant to Section 20(d) of the Securities Act [15 U.S.C § 77t(d)].

JURISDICTION AND VENUE

13. This Court has jurisdiction over this action pursuant to Section 22(a) of the Securities Act [15 U.S.C. § 77v(a)].

14. Defendants, directly or indirectly, have made use of the means or instruments of transportation or communication in interstate commerce or of the mails in connection with the transactions, acts, practices, and courses of business alleged herein.

15. Venue is proper in the Southern District of New York pursuant to Section 22(a) of the Securities Act [15 U.S.C. § 77v(a)]. Among other acts, Ripple has an office in this District. Garlinghouse made certain statements at issue in this case while physically present in this District. All Defendants sold or orchestrated sales of XRP to purchasers residing in this District and enlisted entities domiciled in this District to sell the securities at issue in this case.

DEFENDANTS

16. **Ripple**, f/k/a Open Coin, Inc., is a Delaware corporation founded in September 2012, with its principal place of business in San Francisco, California, and an office in Manhattan.

17. **Garlinghouse**, age 49, is a California resident who was Ripple's chief operating officer ("COO") from April 2015 through December 2016, and who has served as its CEO from January 2017 to the present.

18. **Larsen**, age 60, is a California resident who co-founded Ripple and served as its CEO from September 2012 through December 2016, and who today serves as executive chairman of Ripple's Board of Directors. Larsen received nine billion XRP shortly after Ripple's founding. In 2005 Larsen co-founded, and through 2011 served as the CEO of, a company sued by the SEC in November 2008 for violating Sections 5(a) and (c) of the Securities Act.

RELATED ENTITY AND INDIVIDUALS

19. **XRP II, LLC,** f/k/a XRP Fund, LLC ("XRP II"), is Ripple's wholly-owned subsidiary. It was founded in approximately 2013, has been organized as a New York limited liability company since at least 2015, and is the entity through which Ripple offered and sold most of its XRP in the Offering. XRP II is registered as a money service business with the United States Financial Crimes Enforcement Network ("FinCEN") and as a virtual currency business with the New York State Department of Financial Services ("NYDFS").

20. **Co-Founder**, age 45, is a California resident who co-founded Ripple and received nine billion XRP shortly after Ripple's founding.

21. **Cryptographer-1**, age 51, is a California resident who served as Ripple's chief cryptographer until July 2018 and is currently Ripple's chief technology officer.

22. **Ripple Agent-1**, age 55, is a California resident who co-founded Ripple and received two billion XRP shortly after Ripple's founding.

23. **Ripple Agent-2**, age 42, is a Florida resident who served as Ripple's "Head of XRP Markets" from November 2016 through April 2020.

24. **Ripple Agent-3,** age 36, is a California resident who served as Ripple's executive vice president of business development from February 2013 to January 2015, and its senior vice president of business development from February 2015 through May 2018.

STATUTORY AND LEGAL FRAMEWORK

25. Congress enacted the Securities Act to regulate the offer and sale of securities. In contrast to ordinary commercial principles of caveat emptor, Congress enacted a regime of full and fair disclosure, requiring a company (an issuer) and its control persons who offer and sell securities to the investing public to provide sufficient, accurate information to allow investors to make informed decisions before they invest.

26. Sections 5(a) and 5(c) of the Securities Act require that an issuer of securities like Ripple, and its control persons and affiliates like Larsen and Garlinghouse, register offers and sales of those securities with the SEC when they offer and sell securities to the public, absent certain exemptions that do not apply to Defendants' transactions. Registration statements relating to an offering of securities thus provide public investors with material information about the issuer and the offering, including financial and managerial information, how the issuer will use offering proceeds, and the risks and trends that affect the enterprise and an investment in its securities.

27. Section 5 of the Securities Act is all embracing; it prohibits any unregistered securities offering. Through exemption provisions like Section 4 of the Securities Act [15 U.S.C. § 77d], however, Congress distinguished between (1) sales by issuers of their securities into public markets, which require registration, and (2) ordinary trading transactions in the market by investors, once the securities have come to rest with them, which typically are exempted from registration.

28. Congress sought to provide the protections afforded by registration both where securities are sold directly to the public by the issuer, and where they are publicly sold through an intermediary who buys the stock from the issuer with a view to public resale, *i.e.*, "underwriters." 15 U.S.C. § 77b(a)(11). Congress enacted a broad definition of underwriter to include all persons who might operate as conduits for securities being placed into the hands of the investing public.

29. An issuer's sales of securities may be exempt from registration provided they are not part of a public offering. Securities distributions, or public offerings, by issuers, with or without the use of underwriters, are not exempt from registration and must be registered under Section 5. Exemptions and safe harbors from registration are structured to exempt transactions where the purpose and protections of registration have been otherwise satisfied. The party claiming an exemption bears the burden of showing the transaction is entitled to one.

30. After an issuer registers the offer and sale of its securities under the Securities Act, the Exchange Act requires it to make periodic and current public disclosures, including annual, quarterly, and current reports that provide similar disclosure, including a description of the issuer's business, management's discussion and analysis, disclosure of significant events, and financial information. These filings are necessary to achieve the statutory goal of enabling investors in the offering, as well as would-be purchasers in secondary transactions, to make informed decisions.

31. The definition of a "security" under the Securities Act includes a wide range of investment vehicles, including "investment contracts." Investment contracts are instruments

through which a person invests money in a common enterprise and reasonably expects profits or returns derived from the entrepreneurial or managerial efforts of others. Courts have found that novel or unique investment vehicles constitute investment contracts, including interests in orange groves, animal breeding programs, railroads, mobile phones, and enterprises that exist only on the Internet. As the United States Supreme Court noted in *SEC v. W.J. Howey Co.*, Congress defined "security" broadly to embody a "flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." 328 U.S. 293, 299 (1946).

<u>BACKGROUND ON DIGITAL ASSETS AND DISTRIBUTED LEDGERS</u>

32. The term "digital asset" or "digital token" generally refers to an asset issued and/or transferred using distributed ledger or blockchain technology, including assets sometimes referred to as "cryptocurrencies," "virtual currencies," digital "coins," and digital "tokens."

33. A blockchain or distributed ledger is a peer-to-peer database spread across a network of computers that records all transactions in theoretically unchangeable, digitally recorded data packages. The system relies on cryptographic techniques for secure recording of transactions.

34. Blockchains typically employ a consensus mechanism to "validate" transactions, which, among other things, aims to achieve agreement on a data value or on the state of the ledger.

35. Digital tokens may be traded on digital asset trading platforms in exchange for other digital assets or fiat currency (legal tender issued by a country), at times by being allocated to investors' accounts in the records of the platform (*i.e.*, "off-chain"), without necessarily being transferred from one blockchain address to another (*i.e.*, "on-chain").

36. Some digital assets may be "native tokens" to a particular blockchain—meaning that they are represented on their own blockchain, though other digital assets may also be represented on that same blockchain. Native tokens typically serve a number of technical functions on a distributed

ledger, such as helping secure the ledger from manipulation or other forms of attacks. Like other "digital tokens," native tokens may also be sold and traded for consideration.

37. On July 25, 2017, the SEC issued the *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO*, advising "those who would use . . . distributed ledger or blockchain-enabled means for capital raising[] to take appropriate steps to ensure compliance with the U.S. federal securities laws," and finding that the offering of digital assets at issue in that report were investment contracts and, therefore, securities.

FACTS

I. The Creation of XRP

A. Larsen and Co-Founder Established Ripple

38. In approximately late 2011 or early 2012, Co-Founder began working on the idea and code for what would become the "XRP Ledger" (a/k/a "Ripple Protocol"). Around that time, he recruited Cryptographer-1 and Ripple Agent-1 to assist him in programming the XRP Ledger.

39. The XRP Ledger—software code—operates as a peer-to-peer database, spread across a network of computers, that records data respecting transactions, among other things.

40. During the process to achieve consensus with respect to a new proposed state of the XRP Ledger, each server on the network evaluates proposed transactions from a subset of servers it trusts not to defraud it, also known as the server's "UNL" or "Unique Node List." While each server defines its own trusted servers, the XRP Ledger requires a high degree of overlap between the trusted nodes chosen by each server. Ripple thus publishes its own proposed UNL.

41. Approximately 40% of the nodes validating transactions on the XRP Ledger are operated by organizations or entities based in the United States, including Ripple itself.

42. In 2012, Co-Founder hired Larsen to be the CEO of a newly formed company that would continue the XRP Ledger and XRP projects.

43. As CEO, Larsen ran Ripple's day-to-day operations and was responsible for all aspects of company products and strategy and for the growth of and investment in the company. Larsen solicited and participated in meetings with current and prospective Ripple equity and XRP investors and regularly updated Ripple's Board of Directors and shareholders.

44. In September 2012, Co-Founder, Larsen, and Ripple Agent-1 founded Ripple.

45. Upon the completion of the XRP Ledger in December 2012, and as its code was being deployed to the servers that would run it, Co-Founder, Ripple Agent-1, and Cryptographer-1 created—at little cost—the final version of what today is a fixed supply of 100 billion XRP.

46. Co-Founder, Larsen, and Ripple Agent-1 then transferred 80 billion XRP to Ripple and the remaining 20 billion XRP to themselves—9 billion XRP each to Co-Founder and Larsen and 2 billion XRP to Ripple Agent-1—as compensation for Ripple's founders. After this transfer, Ripple and its founders controlled 100% of XRP.

47. As Cryptographer-1—a well-respected and known Ripple spokesperson—stated in a recent tweet (on Twitter): "The people who created XRP are pretty much the same as the people who created Ripple and they created Ripple originally to, among other things, distribute XRP."

48. XRP, also software code, is a digital asset and the native token on the XRP Ledger.

49. Ripple and Larsen originally called XRP "Ripple Credits" and, for several years thereafter, participants in the digital asset space simply referred to the digital asset as "Ripples."

50. Ripple could do little with its billions of XRP at that time, however, and Ripple had limited funds to pursue any operations it may have sought to undertake. Ripple determined to create a market for and sell XRP to the public to monetize its holdings and finance its operations.

B. Ripple's Lawyers Warned Ripple and Larsen that XRP Could Be a Security

51. Ripple sought the advice of an international law firm regarding certain state and federal legal risks associated with the distribution and monetization of XRP.

52. The law firm provided two memos—one on February 8, 2012 and another on October 19, 2012 (the "Legal Memos")—that analyzed these risks. The first memo was addressed to the Co-Founder and another individual, and the second to Larsen, the Co-Founder, and Ripple.

53. The Legal Memos warned that there was some risk that XRP would be considered an "investment contract" (and thus a security) under the federal securities laws depending on various factors. These included, among other things, how Ripple promoted and marketed XRP to potential purchasers, the motivation of such purchasers, and Ripple's other activities with respect to XRP. If individuals purchased XRP "to engage in speculative investment trading" or if Ripple employees promoted XRP as potentially increasing in price, the Legal Memos warned that Ripple would face an increased risk that XRP units would be considered investment contracts (and thus securities).

54. Both memos warned that XRP was unlikely to be considered "currency" under the Exchange Act because, unlike "traditional currencies," XRP was not backed by a central government and was not legal tender.

55. The October 2012 Legal Memo also advised Ripple and Larsen to contact the SEC to obtain clarity as to whether XRP was a security under the federal securities laws.

56. By at least 2013, Larsen was aware of the contents of the Legal Memos.

57. On May 26, 2014, Larsen explained in an email to an individual formerly associated with Ripple that the international law firm that wrote the Legal Memos advised "that investors and employees could not receive XRP" because that "could risk SEC designation [as] a security." Larsen also explained that the XRP he received upon Ripple's founding was "comp[ensation] for . . . personally assuming th[e] risk" of being deemed the issuers of securities—namely, XRP.

58. In other words, as Larsen himself explained, he was paid at the outset in an asset (potentially worth hundreds of millions of dollars) to assume a risk he knew existed—that the sale of the asset could constitute an offering of securities for which he would be held responsible.

59. Despite this knowledge and Larsen's familiarity with Section 5 from the SEC enforcement action that his previous company had settled in 2008 while Larsen was its CEO, Ripple and Larsen failed to heed some of the legal advice and warnings in the Legal Memos. Neither contacted the SEC to obtain clarity about the legal status of XRP before engaging in a large-scale distribution. Moreover, as described in more detail below, Ripple and Larsen (and later Garlinghouse) offered, sold and promoted XRP as an investment—precisely the type of conduct the Legal Memos had warned could lead to a determination that XRP was a security.

60. In addition, Ripple and Larsen (and later Garlinghouse) never filed a registration statement with the SEC prior to offering or selling XRP. Nor did they limit their sales of XRP to transactions that fit within legal exemptions to the registration requirements of the Securities Act. In other words, Ripple and Larsen embarked on a large-scale unregistered public distribution of XRP and—with the goal of immense profits—simply assumed the risk that they were violating the federal securities laws.

C. Ripple Began to Distribute XRP

61. From 2013 through 2014, Ripple and Larsen made efforts to create a market for XRP by having Ripple distribute approximately 12.5 billion XRP through "bounty programs" that paid programmers compensation for reporting problems in the XRP Ledger's code. As part of these calculated steps, Ripple distributed small amounts of XRP (typically between 100 and 1,000 XRP per transaction) to anonymous developers and others to establish a trading market for XRP.

62. At the same time, Ripple began to make public statements with respect to XRP (then Ripple Credits) that began to create in investors an expectation of profit based on Ripple's efforts.

63. For example, in a promotional document Ripple circulated to potential investors around May 2013, Ripple explained that its "business model is based on the success of its native

currency," that it would "keep between 25% to 30%" of XRP, and noted the "record highs" of prices other digital assets had achieved as something Ripple hoped to emulate for XRP.

64. On May 12, 2013, Cryptographer-1 posted on *Bitcoin Forum*, a popular digital asset forum: "As a corporation, we are legally obligated to maximize shareholder value. With our current business model, that means acting to increase the value and liquidity of XRP. We believe this will happen if the Ripple network is widely adopted as a payment system. . . . One would expect increased demand to increase price."

II. Ripple Made Unregistered Offers and Sales in Connection with XRP Distributions

A. Ripple's Plan to Distribute XRP

65. By at least late 2013, Ripple and Larsen viewed the "Goal of Distribution" for XRP as achieving "Network Growth" and "Rais[ing] funds for Ripple Labs operations," as reflected in at least one internal Ripple document titled the "XRP Distribution Framework."

66. Ripple began its efforts by attempting to increase speculative demand and trading volume for XRP though, at first, it did not articulate a single specific strategy about which type of entities or persons it would target to encourage adoption of XRP for any particular non-investment use. As Cryptographer-1 put it in 2013, Ripple was working on "multiple avenues" at the time.

67. Starting in at least 2015, however, Ripple decided that it would seek to make XRP a "universal [digital] asset" for banks and other financial institutions to effect money transfers.

68. According to Ripple's plans, to create acceptance for the universal digital asset, Ripple first had to create an active, liquid XRP secondary trading market. It therefore continued its efforts to develop a use for XRP while increasing sales of XRP into the market. Under the plan, a future "user" of XRP as a universal asset (*i.e.*, a bank) would use the speculative trading market to effect money transfers.

69. In other words, Ripple's stated business plan made Ripple's conduct alleged here a foregone conclusion—Ripple made it part of its "strategy" to sell XRP to as many speculative investors as possible. While Ripple touted the potential future use of XRP by certain specialized institutions, a potential use it would deploy investor funds to try to create, Ripple sold XRP widely into the market, specifically to individuals who had no "use" for XRP as Ripple has described such potential "uses" and for the most part when no such uses even existed.

70. Ripple also lacked the funds to pay for these endeavors and for its general corporate business expenses, which for 2013 and 2014 already exceeded $25 million, without selling XRP.

71. Ripple's objectives and its own financial reality thus compelled it to actively seek to offer and sell XRP as widely as possible, while controlling supply and demand in the resale market to manage and control liquidity for an imagined, future "use" case.

72. In August 2013, Ripple started making unregistered offers and sales of XRP in exchange for fiat currencies or digital assets such as bitcoin.

73. Larsen orchestrated the initial stage of Ripple's Offering of XRP by approving the timing and amount of offers and sales to: (1) purchasers in the open market ("Market Sales"); (2) investment funds, wealthy individuals, or other sophisticated investors ("Institutional Sales"); and (3) others enlisted to assist Ripple's efforts to develop an XRP market (the "Other XRP Distributions").

74. Garlinghouse joined Ripple as COO in April 2015 and substantially assisted its ongoing unregistered Offering by, among other things, being responsible for its operations. In January 2017, Garlinghouse became CEO and Larsen retained his role as chairman of the Board.

75. After the change in corporate structure, both Garlinghouse and Larsen remained key decision makers and participants in Ripple's ongoing Offering. As CEO, Garlinghouse approved the timing and amounts of unregistered offers and sales of XRP, and, as chairman of the Board, Larsen was consulted on such offers and sales. Both continue to communicate with potential and

actual XRP investors and Ripple equity shareholders and to participate in certain projects Ripple is pursuing with respect to XRP. Both have continued selling XRP into public markets.

76. In 2017, Defendants also began accelerating Ripple's sales of XRP because, while Ripple's expenses continued to increase (reaching nearly $275 million for 2018), its revenue outside of XRP sales did not.

77. For example, starting in 2016, Ripple began selling two software suites, xCurrent and xVia, from which it has earned approximately $23 million through 2019, though neither uses XRP or blockchain technology. Ripple raised about $97 million in sales of equity securities through 2018 and an additional $200 million in 2019. In other words, the overwhelming majority of Ripple's revenue came from its sales of XRP, and Ripple relied on those sales to fund its operations.

B. Overview of Ripple's XRP Distribution

78. Ripple's planned distribution of XRP succeeded.

79. From 2014 through the end of 2019, to fund its operations, Ripple sold at least 3.9 billion XRP through Market Sales for approximately $763 million USD.

80. From 2013 through the end of the third quarter of 2020, Ripple sold at least 4.9 billion XRP through Institutional Sales for approximately $624 million USD, also to fund Ripple's operations, for a total of at least $1.38 billion USD in Market and Institutional Sales alone.

81. The market price for XRP—and Ripple's sales prices in the Offering—ranged from a low price of approximately $0.002 per XRP in 2014 to a high price of $3.84 per XRP in early 2018, an increase of nearly 137,000%. XRP traded at approximately $0.58 USD per XRP as of last week.

82. Ripple also undertook to achieve its goal of widespread distribution of XRP by exchanging XRP for non-cash consideration, such as labor and market-making services. Through the Other XRP Distributions, Ripple paid third parties to assist in its efforts to accomplish as widespread a distribution of XRP as possible and to attempt to develop a "use" for XRP.

83. Since 2014, Defendants have disbursed at least 4.05 billion XRP (valued at at least $500 million USD when the XRP was distributed) through Other XRP Distributions.

84. In addition, Larsen (beginning in 2015) and Garlinghouse (beginning in 2017) directly participated in the Offering by offering and selling their own holdings of XRP into the same market as Ripple's Market Sales, typically following the same manner of sale.

85. From 2015 through at least March 2020, while Larsen was an affiliate of Ripple as its CEO and later chairman of the Board, Larsen and his wife sold over 1.7 billion XRP to public investors in the market. Larsen and his wife netted at least $450 million USD from those sales.

86. From April 2017 through December 2019, while an affiliate of Ripple as CEO, Garlinghouse sold over 321 million XRP he had received from Ripple to public investors in the market, generating approximately $150 million USD from those sales.

87. Defendants offered and sold XRP to any person, without restricting offers or sales to persons who had a "use" for XRP (particularly given that little to no "use" existed until Ripple subsidized some "use" operations in recent months, as described below) and without restricting anyone's ability to resell their XRP to investors within the United States or elsewhere.

88. With respect to all four types of distribution (Market Sales, Institutional Sales, Other XRP Distributions, and Individual Defendants' XRP Sales), Defendants understood that XRP purchasers routinely resold XRP to other investors in the United States and other countries. These resales aligned with Defendants' own goals of achieving as widespread a distribution of XRP as possible, which was necessary to promote an aftermarket of buyers and sellers of XRP.

89. Defendants sold approximately 14.6 billion XRP, as summarized in Table 1, below.

Type of Sales	**Approximate Amount of XRP Sold & Distributed**
Market Sales	3.9 billion
Institutional Sales	4.9 billion
Other XRP Distributions	4.1 billion
Individual Defendants' XRP Sales – Larsen	1.7 billion
Individual Defendants' XRP Sales – Garlinghouse	321 million*
Total Offering	**14.6 billion**

* Counted in "Other XRP Distributions" Only

Table 1: Total Defendants' XRP Sales & Distributions in the Offering

C. Defendants' Market Sales of XRP

90. As CEO, Larsen initiated and approved Ripple's Market Sales of XRP.

91. Ripple conducted the Market Sales first by transferring ownership of XRP on the XRP Ledger directly to investors and later by using traders who specialized in algorithmic digital asset trading to offer and sell XRP to investors, both on the XRP Ledger and on digital asset trading platforms, both in exchange for fiat currencies or other digital assets such as bitcoin.

92. The entities Defendants enlisted to help carry out the Market Sales—the specialized traders or the trading platforms—were typically not registered with the SEC in any capacity.

93. Ripple conducted the Market Sales by paying at least four entities commissions, paid in XRP, for executing Ripple's XRP sales to the public on digital asset trading platforms.

94. One of these entities is based in New York and was registered with the SEC as a broker-dealer until December 2019. One of the other entities is also based in the United States, while another entity is internationally-based but has offices in the United States. The fourth entity, through which Ripple conducted most of the Market Sales, is a global digital asset trading firm with an office in the United States (the "Market Maker").

95. To increase Market Sales throughout the Offering, Ripple has also directed all readers of its website to information about "How to Buy XRP" and has provided a list of digital asset trading platforms, including some with principal places of business in the United States, on which investors can make those purchases.

96. While each was CEO, Larsen and Garlinghouse had final decision-making authority over which trading venues to use for Market Sales and how much XRP to sell on a particular venue, which Ripple communicated to traders as an overall percentage of XRP's daily trading volume.

97. At Ripple's direction, the intermediaries such as the Market Maker ensured that Market Sales were programmatically set not to exceed a certain percentage of XRP's overall daily trading volume, and Ripple referred to the Market Sales as "programmatic sales."

98. On occasion, Ripple employees or the Market Marker consulted Larsen and Garlinghouse as to parameters for conducting Ripple's Market Sales, which they at times approved.

D. Defendants' Public Distribution through Institutional Sales of XRP

99. Since at least 2013, Ripple and Larsen tried to make Institutional Sales to obtain essential funding for Ripple's operations and develop a speculative trading market in XRP.

100. Ripple viewed the Institutional Sales as the lynchpin of its strategy to generate speculative interest in XRP from public investors. As Ripple stated in a document published on its website on January 24, 2017, which Ripple Agent-2 authored, Ripple's Institutional Sales of XRP were "indicative of [XRP's] broader capital market potential."

101. Ripple—through its agents, including Larsen and Garlinghouse—offered and sold XRP for investment to influential players in the digital asset space, including XRP market makers, dealers, and blockchain-focused private investment funds looking to create an XRP-based fund or include XRP in their fund. These market makers were also typically not registered with the SEC.

102. With a few exceptions, Ripple conducted the Institutional Sales through XRP II, which applied for a license with the NYDFS to engage in the "virtual currency business activity" of selling "units of Ripple's virtual currency . . . to institutional and other accredited investors" who are "purchasing XRP for speculative purposes."

103. From 2013 to the present, Ripple has made Institutional Sales to at least twenty-six institutional investors.

104. Ripple made many of the XRP Institutional Sales at a discount from XRP market prices. At least seven of the institutional investors—including some described below—bought XRP at discounts between 4% and 30% to the market price

105. The agreements governing Ripple's Institutional Sales typically provided no restrictions on the buyer's ability to resell XRP, provided only brief lock-up periods (during which the investor could not resell its XRP) of typically three to twelve months, or limited the buyer's ability to resell quantities of XRP that could potentially lower XRP's trading price.

106. In other words, Ripple expected that most, if not all, Institutional Sales buyers would sell their XRP into public markets and tried to protect XRP's trading price by limiting the amounts that could be resold during any given time period. By selling at discounts to market prices, Ripple incentivized these buyers to seek to sell their XRP into the public markets in order to realize what was essentially a guaranteed profit.

107. The paragraphs below describe three examples of Institutional Sales.

108. On June 12, 2017, Larsen and others employees met with an investment fund ("Institutional Investor A"), which Ripple Agent-2 described in a June 12, 2017 email to Ripple Agent-3 as "a $12B [$12 billion] alternative asset hedge fund based out of New York."

109. In 2017, Ripple sold approximately 14.8 million XRP for $2.1 million to Institutional Investor A, without restricting Institutional Investor A's ability to resell this XRP into public markets in any way, at price discounts of up to 30% below XRP market prices.

110. From at least 2016 through 2019, Ripple sold approximately 115 million XRP to an entity ("Institutional Investor B") that describes itself as a "full-service digital currency prime broker" that "provide[s] investors with a secure marketplace to trade, borrow, lend & custody digital currencies." Institutional Investor B paid Ripple approximately $6.4 million for its XRP, the first $500,000 of which it obtained at a 10% discount from XRP market prices.

111. Under the terms of its agreement with Ripple, Institutional Investor B—whose principal place of business is in Manhattan—agreed to resell its XRP subject to volume limitations to be specified at the time of each subsequent purchase. Ripple did not restrict the entity's ability to resell XRP into the market in any other way.

112. On September 24, 2018, Ripple entered into an agreement (as amended, "Institutional Investor C Sales Agreement"), signed by Garlinghouse with a Japanese entity ("Institutional Investor C") that describes itself as "operat[ing] sales and exchange service[s] of crypto-assets to offer safe and secure transactions of crypto-assets for as many people as possible."

113. Pursuant to the Institutional Investor C Sales Agreement, Ripple agreed to make up to $1 billion worth of XRP available for purchases to Institutional Investor C from November 1, 2018 through November 1, 2021, $800 million of which was offered at prices discounted between 15% and 30% below XRP's market price, depending on the total amount of XRP purchased by Institutional Investor C.

114. Pursuant to the Institutional Investor C Sales Agreement, Institutional Investor C agreed to limit the amount of its own "sales or transfers of XRP" to not exceed 10 basis points of the average daily volume of XRP trading in the market (a basis point is .0001 or 1/100th of 1%).

115. From 2018 through the end of 2019, Ripple sold over $170 million worth of XRP, approximately 719 million XRP, to Institutional Investor C, sold approximately 361 million XRP to Institutional Investor C through the end of September 2020, and at least another 20 million XRP around December 15, 2020.

116. Table 2 specifies the amounts Ripple raised in both Market and Institutional Sales:

Year or Other Time Period	Total XRP Market Sales in USD	Total XRP Institutional Sales in USD	Total Funds Ripple Raised from Certain XRP Sales
2013		$2,572,286.07	$2,572,286.07
2014	$2,535,979.74	$14,722,984.79	$17,258,964.53
2015	$6,912,557.86	$10,939,378.47	$17,851,936.33
2016	$6,239,994.34	$10,094,945.99	$16,334,940.32
2017	$116,709,100.04	$67,124,274.31	$183,833,374.35
2018	$362,727,751.01	$171,715,041.56	$534,442,792.57
2019	$268,249,195.38	$231,993,578.98	$500,242,774.36
2020 (through third quarter)	$0	$115,689,994.15	$115,689,994.15
Total	**$763,374,578.38**	**$624,852,484.32**	**$1,388,227,062.70**

Table 2: Funds Raised in Offering from Certain XRP Sales

E. Defendants' Other XRP Distributions and "Listing" of XRP on Digital Asset Trading Platforms

117. At times, rather than directly selling XRP into the market to fund its operations, Ripple funded its dual XRP market-creating and company financing goals by transferring XRP to third parties as compensation. Ripple understood that these parties would in turn sell XRP into the public markets (often explicitly dictating the terms under which the parties could make these sales).

118. These Other XRP Distributions consist of five other types of sales and distributions of XRP in return for cash or other consideration, described below.

1. Executive Compensation Distributions

119. Between December 2016 and at least May 2019, Ripple granted certain of its executives a total of approximately 900 million XRP in consideration for their labor as Ripple employees, at least 597 million of which Ripple has already tendered to these executives.

120. On December 13, 2016, Ripple granted Ripple Agent-3 and Garlinghouse 150 million and 500 million XRP, respectively, in separately negotiated compensation agreements.

121. Ripple granted Garlinghouse an additional 250 million XRP on May 29, 2019.

122. Pursuant to the terms of these agreements, Ripple has transferred approximately 521 million XRP to Garlinghouse and approximately 76 million XRP to Ripple Agent-3, worth approximately $246 million and $44 million, respectively, at the time of transfer.[1]

2. On-Demand Liquidity Distributions

123. As described below, in late 2018 Ripple began to market a product ("On-Demand Liquidity" or "ODL," also called "xRapid") for money transmitting businesses to buy XRP in one jurisdiction, transfer it to a separate destination, and sell XRP for the local fiat currency, to effect cross-border payments. To encourage adoption of ODL, Ripple paid XRP to both the money transmitting businesses and certain market makers that supported the product for their efforts.

124. Ripple chose to compensate these entities (which were not investors in XRP) with XRP directly, understanding that they would monetize their fees by selling XRP into public markets.

125. From approximately December 2018 through July 2020, Ripple issued at least 324 million XRP as fees, rebates, and incentives to entities associated with ODL, without restricting the ability of these entities to resell the XRP received as incentives into public markets. This XRP was valued at approximately $67 million at the time of Ripple's payments.

126. These entities typically have resold all the XRP they have received from Ripple to investors in the public markets, typically on the same day that they received the XRP from Ripple.

127. Ripple took no steps to ensure that these entities intended to hold XRP as an investment. To the contrary, Ripple gave these entities XRP to sell into the public markets.

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1 These values are based on the weighted average of XRP's closing price for a particular day, month, or quarter, as reported by the digital asset platform Coinmarketcap.

3. Sales of XRP into the Market on Behalf of a Larsen-Established Entity and by Ripple-Funded Projects.

(i) RippleWorks

128. In 2015 and 2017, Ripple issued at least 2 billion XRP as contributions to "RippleWorks," an entity Larsen co-founded to invest in, among other things, XRP-related projects to further Ripple's goals of achieving widespread trading of XRP in the market.[2]

129. Larsen co-founded RippleWorks with another individual who would become its CEO (the "RippleWorks CEO") in mid-2015. Larsen donated one billion of his own XRP to RippleWorks, and Ripple's Board, including Larsen, approved giving 1 billion XRP to RippleWorks, in part because the Board "believe[d] [RippleWorks] will help promote [Ripple's] business." On February 1, 2017, Ripple committed an additional one billion XRP to RippleWorks.

130. RippleWorks worked to achieve Ripple's own goal of widespread distributions of XRP, with Larsen supervising RippleWorks' sales of XRP into the market.

131. Ripple took no steps to ensure that RippleWorks intended to hold XRP as an investment. To the contrary, Ripple gave XRP to RippleWorks so it would sell XRP into the public markets and, from mid-2015 to the present, enlisted the Market Maker to sell approximately 693 million XRP to the public on RippleWorks' behalf, for approximately $176 million.

132. A November 11, 2016 email from the RippleWorks CEO to Larsen and Garlinghouse exemplifies the relationship between the two entities. In the email, the RippleWorks CEO detailed RippleWorks' "2016 Year End XRP selling" and "2017 XRP Sales" in order to "insure [sic] we are all on the same page and allow anyone to chime in with any different thoughts."

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[2] In a November 21, 2019 tweet, Larsen explained that RippleWorks had "distribute[d] $25M+" to a number of ventures, which then presumptively resold the XRP into public markets.

133. Another example involves RippleWorks' eventual investment into a fund that wished to invest in digital assets (the "XRP Fund") and Ripple's "loan" of XRP to that fund so that it could engage in market-making activities.

134. In an August 27, 2017 weekly update email, Ripple Agent-3 informed Garlinghouse that the XRP Fund and Ripple had exchanged a term sheet.

135. In an October 2, 2017 weekly update email, Ripple Agent-3 informed Garlinghouse that Ripple was "evaluating setting up [an investment in the XRP Fund] through RippleWorks."

136. On November 1, 2017, Ripple Agent-3 informed Ripple Agent-2 that Ripple was looking to "accelerate/prioritize XRP-beneficial announcements," including potentially the formation of the XRP Fund.

137. On November 11, 2017, a Ripple marketing executive asked Garlinghouse and Ripple Agent-3 in an email if they could use an upcoming investment conference in Manhattan to "push" the XRP Fund or the RippleWorks CEO "to close so we can announce." The next day, Ripple Agent-3 informed Garlinghouse that Ripple was "following up with [the RippleWorks CEO] with some provisions [for the XRP Fund] to prevent harmful XRP behavior."

(ii) Third-Party Incentives Through "xPring"

138. From approximately April 2018 through August 2020, Ripple publicly marketed an initiative it called "xPring," through which it distributed over 776 million XRP to at least 27 different entities or projects with the shared expectation that the entities would resell XRP to further Ripple's goals of achieving widespread XRP distribution. Ripple called xPring "a new initiative by Ripple that will invest in, incubate, acquire and provide grants to companies and projects run by proven entrepreneurs" in hopes of achieving Ripple's stated goal of working to develop a use for XRP.

139. Ripple used xPring as yet another way to get XRP into the hands of public investors through conduits, while obtaining the added benefit of incentivizing third parties to help Ripple

pursue its XRP goals. Ripple gave XRP to these entities so they would sell it into public markets and took no steps to ensure that xPring-funded parties would not resell their XRP to the public.

140. For example, a November 1, 2018, two-year "Services and Marketing Agreement" with one entity promised "certain development services to promote technologies of interest to Ripple." The agreement provided that the entity would receive a bi-monthly "development service fee" of 5 million XRP and could identify additional parties that could receive XRP as incentives—provided that these additional parties agreed to abide by Ripple-mandated parameters for their XRP trading volumes. By August 2020, Ripple had paid the entity at least 364 million XRP, of which the entity had distributed 178 million to other parties, typically approved by Ripple.

141. Another such distribution included a November 8, 2018 agreement wherein Ripple agreed to pay a company up to $17.5 million in XRP if the company met certain "milestones" relating to the "integration" of XRP into the company's systems. Understanding the business reality that the company would seek to resell the XRP it received from Ripple, Ripple again required the entity to agree to certain volume-related parameters to effect XRP sales into the market. Ripple eventually transferred more than 163 million XRP to this entity.

4. The XRP Options

142. From January 2018 through December 2019, Ripple sold at least 1.63 billion XRP when certain entities exercised options to buy XRP that Ripple had granted (the "Option Sales").

143. In February 2016, Ripple granted "an option to purchase units of Ripple XRP" to a California-based fund ("Option Investor A") that invests in technology-related startups "[i]n exchange for advisory services provided" to Ripple by Option Investor A's founder. Ripple granted options for up to one billion XRP as of January 1, 2014, at prices to be determined based on XRP's average market prices. The options are from January 1, 2018, and for each month thereafter, until

March 1, 2022. Between 2018 and September 2020, Ripple's sales to Option Investor A consisted of at least 588 million XRP.

144. Separately, in 2016, Ripple entered into an agreement with an enterprise software firm ("Option Investor B") based in Manhattan that gave the firm an option to buy up to 5 billion XRP at a discounted price in exchange for efforts to help Ripple develop a "use" for XRP. The amount of XRP available for purchase under the option was later reduced, and Option Investor B purchased at least 1.04 billion XRP in 2019.[3]

5. Payments to Digital Asset Trading Platforms to Support XRP's Trading Market

145. In 2017 and 2018, Ripple also entered into agreements with at least ten digital asset trading platforms—none of which were registered with the SEC in any capacity, and at least two of which have principal places of business in the United States—providing for listing and trading incentives with respect to XRP. Ripple paid these platforms a fee, typically in XRP, to permit the buying and selling of XRP on their systems and sometimes incentives for achieving volume metrics.

146. As just one example of these arrangements, in May 2017, Ripple gave a digital asset trading platform, based in the United States, 17 million XRP in exchange for the platform's agreement to make XRP available to buy and sell on its platform, as well as rebates on trading fees of up to $60,000 per month for three months, and up to $150,000 in incentive payments per month for three months to the top three traders of XRP for other assets on the platform.

147. Between October 2016 and October 2017, Ripple distributed approximately 28 million XRP to these platforms, with a then-current market value of $6.8 million.

[3] To pressure Option Investor B to sell back the option grant (which covered approximately 5% of the XRP in existence at a reduced price), Ripple Agent-3 suggested to Ripple Agent-2 in an email on February 26, 2017 that Ripple make the option public. Ripple Agent-2 responded that it "would cause us some headaches . . . Better to keep it private."

148. As reflected in internal documents, Ripple made these efforts because it believed that increased trading volume for XRP on digital asset trading platforms would create "momentum" for XRP. For example, as Ripple Agent-3 instructed a Ripple employee and an XRP investor in June 2017, Ripple had to "load[ ] with ultimatums" any conversation with one particular Manhattan-based digital asset trading platform, because it was a "HIGH VALUE target" for Ripple.

149. Ripple tried repeatedly and unsuccessfully to persuade that digital asset trading firm to "list XRP on [its] exchange" by offering to "cover implementation costs, paying rebates, [and] brokering intros to large XRP holders for custody." Undaunted by these initial failures, Ripple Agent-3 emailed the two owners of the firm directly in July 2017, copying Garlinghouse, and asked: "Does a $1M cash payment move the needle for a Q3 listing?"

150. Table 3, below, summarizes the Other XRP Distributions.

Type of Other Distribution in the Offering	Time Period	Amount of XRP Sold (or Exchanged for Other Consideration) in the Offering
Executive Compensation	Dec. 2016 to Dec. 2019	597,000,000
On-Demand Liquidity Distributions	Dec. 2018 to July 2020	324,000,000
RippleWorks	Third Quarter 2015 – Present	693,000,000
xPring	Apr. 2018 to Aug. 2020	776,000,000
Option Sales	Nov. 2018 to Sept. 2020	1,637,000,000
Digital Asset Trading Platforms	Oct. 2016 to Oct. 2017	28,400,000
Total		**4,055,400,000**

Table 3: Other XRP Distributions

F. Larsen's and Garlinghouse's Sales of XRP

1. Larsen's Sales

151. At all relevant times, Larsen was either the CEO or chairman of the Board of Directors of Ripple and thus part of the control group of XRP's issuer.

152. While CEO, Larsen had the power to appoint six out of eight seats on Ripple's Board of Directors, and, as Ripple's largest equity shareholder, had 68% of its voting power.

153. The following sales of XRP took place with Larsen working in coordination with Ripple to develop and maintain a liquid market for XRP through which Defendants could monetize their holdings. Email between Larsen and the Market Maker, from at least 2017 through at least 2019, show that, like Ripple and Garlinghouse, Larsen also attempted to strike a delicate balance between maximizing profits from his XRP sales while not depressing the price of XRP.

154. Larsen at times paid the Market Maker to make offers and sales of his XRP on digital asset trading platforms with worldwide operations and customers. Larsen offered and sold his XRP to investors all over the world, including in the United States, without marketing or restricting offers or sales to persons who had a "use" for XRP and without restricting purchasers from reselling their XRP to other investors, including to investors in the United States or elsewhere.

155. Larsen and his wife netted approximately $450 million from these sales.

156. Larsen directed his offers and sales of XRP from within the United States.

157. Larsen intends to continue selling his XRP, as shown in an email he sent an investor on June 30, 2019. The investor had raised concerns about Larsen's continued personal sales of XRP, to which Larsen described the "widely held view that over time, its [sic] better to have widely held assets, so continued reduction of Ripple and founder holdings is likely constructive." On September 22, 2020, Larsen also publicly confirmed from his Twitter account that he had transferred half a billion of his XRP, then worth approximately $115 million, to accounts he

established with a digital asset firm incorporated in New York, and recently did in fact make such transfers, further evidencing his present intention to continue his unregistered sales of XRP.

2. *Garlinghouse's Sales*

158. From April 2015 to the present, Garlinghouse was either the COO or the CEO of Ripple and thus part of the control group of XRP's issuer.

159. After Garlinghouse joined Ripple in 2015, Garlinghouse was awarded XRP from Ripple, aligning his financial incentives with Ripple's. Garlinghouse later resold significant quantities of XRP to amass profits well over one hundred million dollars.

160. The following sales took place with Garlinghouse working in coordination with Ripple to develop and maintain a liquid XRP market that the Defendants could monetize.

161. From April 2017 through December 2019, Garlinghouse sold over 321 million of his XRP, for approximately $150 million, to the public through digital asset trading platforms or other intermediaries. Beginning in December 2017, Garlinghouse used the Market Maker, who deployed trading bots on multiple, worldwide digital asset trading platforms, to sell his XRP to the public.

162. Garlinghouse offered and sold XRP to investors all over the world, including in the United States, without marketing or restricting offers or sales to persons who had a "use" for XRP and without restricting purchasers from reselling their XRP to other investors, including to investors in the United States or elsewhere.

163. Garlinghouse directed his offers and sales of XRP from within the United States.

164. At various times between April 2017 and at least December 2019, Garlinghouse also paused his XRP sales at the Market Maker's recommendation because XRP's market price was falling, seeking to avoid having the latter's own XRP sales further drive down XRP's market price.

165. Recently, Garlinghouse transferred some of his XRP into accounts he opened with digital asset trading platforms, evidencing his intention to continue his unregistered sales of XRP.

III. Defendants Created and Control the XRP Trading Markets While Selectively Disclosing Information about Their Activities

166. Defendants' offers and sales of XRP in the Offering occurred into a market that they had largely created and which—consistent with their dual purposes of raising funds from their XRP sales and managing the liquidity of the XRP market—they played a significant role overseeing.

167. Defendants' efforts in this regard principally involved monitoring the timing and amount of their XRP sales and purchases, sometimes to coincide with strategic announcements about Ripple or XRP, and establishing an escrow for Ripple's own XRP holdings.

168. The ability to sell investments in liquid markets is an important consideration for investors when determining whether to buy securities because it represents one way in which they can realize profits from their investments.

A. Ripple Managed the Price and Liquidity in the XRP Market

169. Throughout the Offering, Ripple—as Garlinghouse and Larsen directed at various times—undertook significant efforts to monitor, manage, and impact the XRP trading markets, including the trading price and volume of XRP.

170. As described in Section II, these efforts included: (1) using algorithms to time the amount and price of Defendants' XRP sales into the market; (2) paying incentives to certain market makers—some of which Ripple engaged to effect the Market Sales—if the sales reached certain trading volume levels on XRP; and (3) paying digital asset trading platforms to permit XRP trading.

171. These efforts also included timing the prices and amounts of XRP sales to achieve what Ripple viewed as desirable trading volume or price levels and fluctuations with respect to XRP. Ripple sought to maximize the amount it could earn from the XRP Market Sales while minimizing volatility and any downward pressure on XRP's market price caused by Ripple's constant injections of new XRP into the market to raise operating funds.

172. Ripple internally described these strategies as aimed at maximizing the amount of money Ripple could raise in the Offering or at achieving "more speculative [XRP] volume." At times, Ripple publicly described its efforts as meant to protect the public's investments in XRP.

173. Starting in late 2015, Ripple directed the Market Maker to buy or sell XRP (on occasion strategically timed around Ripple announcements), to account for the volume impact of XRP trading, as a Ripple executive told the Market Maker by email on September 20, 2016.

174. To accomplish this, Ripple had an internal "XRP Markets Team" that monitored XRP's price and volume daily and regularly communicated with Ripple's XRP market makers about Ripple's XRP sales strategy, which relied on selling XRP in amounts no greater than a certain percentage of XRP's daily volume, generally between 10 and 25 basis points.

175. Starting in 2017 at the latest, Larsen and Garlinghouse participated in meetings with, or were apprised of discussions by, the XRP Markets Team, in which they discussed adjustments to Ripple's sales strategy and recommendations regarding the amount of Ripple's XRP to sell, decisions over which Larsen and Garlinghouse had final authority as Ripple's CEOs.

176. On April 11, 2016, Ripple also directed the Market Maker to buy XRP in the open market with the goal of "[t]arget[ing] $0.008 incrementally over the course of 2 days" while "[c]ap[ping] activity at 5% of daily trading volume[,]" among other things.

177. A few months later, on August 16, 2016, a Ripple employee reported to others at Ripple the "robust discussion activity [he had seen] on the XRPchat thread" (which included "[p]ositive feedback" with respect to "[u]nderstanding that Ripple has a long-term strategy, in which XRP is one of a few big bets") and the "notable market activity" for XRP in recent days. ("XRP Chat is an online forum that describes itself as "[t]he Largest XRP and Ripple Community Forum".)

178. A Ripple vice president of finance (the "VP of Finance") then asked Garlinghouse and Ripple Agent-3 "if [they] discussed whether we should turn off the buying now with this news

and the higher volume?" Ripple Agent-3 responded: "The thesis . . . is to show a period of consistent buying from an account that is known to be a consistent seller. The intended impact of the buying is not to move the price but rather to provide confidence in the market, which in turn will move the price."

179. Following this exchange, Ripple did not "turn off the buying" of XRP.

180. The following month, September 2016, Ripple directed the Market Maker to place XRP buy and sell orders around the time of announcements Ripple made that month referring to Ripple's achievements, though neither announcement concerned XRP.

181. On September 20, 2016, the VP of Finance emailed the Market Maker and said that, after consultation with Garlinghouse and Larsen, Ripple wanted to "better understand[ ] the impact of our purchases [of XRP] over the past week" and that Ripple's "[c]urrent thinking [was] that we should use our full $300k [designated for XRP purchases] in the first 24 hours post announcement."

182. The next day, the Market Maker provided the VP of Finance and Ripple Agent-3 with data showing "the positive relationship between hourly price changes of XRP and the hourly Net XRP purchases," while noting the lack of data to provide a "statistically significant result."

183. On Friday, September 23, 2016, the VP of Finance, after consulting with Garlinghouse and Larsen and obtaining Garlinghouse's "go ahead," directed the Market Maker to "keep the buying light [the day after the announcement] and then do the bigger slug starting Sunday." The Market Maker agreed.

184. On Monday, September 26, 2016, the Market Maker reported to Ripple that it had "spent approximately $200K of the second tranche" and recommended a strategy "to make aggressive markets" going forward, to which the VP of Finance agreed.

185. On October 15, 2016, the VP of Finance informed the Market Maker that, after an upcoming announcement, Ripple "would like to go to sales at 1%" of trading volume and asked the

Market Maker to "be thoughtful / opportunistic around the timing of implementing 1%" because Ripple did not "want to depress the rally but rather capitalize on the additional volume." He further instructed the Marker Maker "to take more money off the table," if there was a chance to do so.

186. Internally, Ripple executives frequently expressed concern over XRP's price and planned proactive steps to protect the market.

187. For example, in an August 12, 2017 e-mail to Ripple Agent-2 and Ripple Agent-3, Garlinghouse raised concerns about XRP being "squarely left out" of a recent market "rally" and asked whether Ripple's recent XRP sales were "impacting the market?" He instructed certain Ripple employees to "proactively" attempt to increase speculative trading value with positive XRP news.

188. Similarly, in September 2019, Ripple's "Head of Global Institutional Markets" reminded certain Ripple employees that Ripple viewed itself as "Responsible Stewards of XRP." She expressed concerns about the impact on XRP's price from increased XRP supply and recommended "buy[ing] [XRP] back" because she was very "worried about xrp at 0.20" and was "DREAD[ING]" an upcoming report—referring to quarterly reports Ripple began publishing in January 2017 (the "Markets Reports")—if Ripple didn't "take swift, creative action now (!)"

189. Defendants did not disclose publicly this XRP buying and selling strategy.

190. But Ripple did publicly tout other actions it was taking to support XRP's market price, including to limit XRP supply or to create scarcity through XRP buybacks.

191. For example, on January 4, 2017, in an effort to assuage XRP investor concerns, Ripple told Institutional Investor C that Ripple "only sells or transfers XRP to financial institutions and accredited investors who bring payment volume and/or FX liquidity to Ripple." Ripple made similar statements publicly, such as on its website, the "XRP Chat," and certain Markets Reports.

192. Similarly, in its Markets Report for the fourth quarter of 2017, Ripple told investors that it placed sales volume "restrictions" on the XRP it sold directly to financial institutions to "mitigate the risk of market instability due to potential subsequent large sales."

193. Later, in approximately June 2020, Ripple employees prepared and delivered an internal presentation for Garlinghouse and Larsen in which the employees highlighted that "XRP began underperforming [Bitcoin]" since early May 2020, partly because of Ripple's sales of XRP. The employees proposed "supply limiting tactics," such as Ripple's buying back XRP.

194. Garlinghouse approved the "buy back" option.

195. Following Garlinghouse's decision, Ripple disclosed on November 5, 2020, in its Markets Report for the third quarter of 2020, that it had purchased $45 million worth of XRP in order to "support healthy markets" and that it may continue to engage in this activity in the future.

B. Defendants Established an XRP Escrow

196. XRP investors became concerned that Ripple's sales could cause XRP's price to crash. As Garlinghouse explained in an internal email on May 16, 2017, XRP investors were concerned that Ripple could "sell its [then] 61.68[ ]B[illion] XRP in the market at any time."

197. If Ripple had filed a registration statement and quarterly and annual reports—as it would have been required to do—Ripple's sales would have been publicly disclosed. They were not.

198. To assuage investor concerns, on May 16, 2017, Ripple announced that it would place 55 billion XRP (most of its current holdings) into a cryptographically-secured escrow that would restrict Ripple to accessing only one billion XRP every month (the "XRP Escrow").

199. Both Larsen and Garlinghouse were instrumental to the formation of the XRP Escrow by developing and, ultimately, approving the idea.

200. An internal Ripple memo prepared by Ripple Agent-3 around April or May 2017 (the "Proposal to Escrow Ripple's XRP") explained that one purpose of the escrow was to "secur[e]

speculative liquidity" in XRP and to "drive a material increase in XRP trading volume/liquidity" by removing uncertainty about when Ripple might dispose of its XRP holdings.

201. The Proposal to Escrow Ripple's XRP noted that Ripple wanted "more XRP liquidity and [that its] efforts are helping, [but] things are not moving as fast as [Ripple] want[s]."

202. The Proposal to Escrow Ripple's XRP concluded that the XRP Escrow would be successful if it resulted in "immediate increase in volume and price appreciation" for XRP as one of the "[r]ewards" to counter-balance the increased "[r]isk" of "Cash flow shortfall" for Ripple.

203. Ripple and Garlinghouse publicly touted the formation of the XRP Escrow as proof that Ripple and XRP holders shared a common interest in the success of Ripple's efforts as to XRP and as one of Ripple's many efforts to manage the trading market for XRP.

204. In other words, by announcing the XRP Escrow, Defendants sought to encourage investors to buy and sell XRP without fear that Ripple could cause XRP's price to crash—as though the XRP market was a functional market subject to ordinary supply and demand independent of the issuer. In doing so, Defendants reminded investors of a fact they already knew—that Ripple was committed to undertaking efforts to increase XRP trading volume while supporting XRP's price.

IV. <u>XRP Was a Security Throughout the Offering</u>

205. As noted, the Supreme Court made clear in its *Howey* decision of 1946 that the definition of whether an instrument is an investment contract and therefore a security is a "flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."

206. At all relevant times during the Offering, XRP was an investment contract and therefore a security subject to the registration requirements of the federal securities laws.

207. Defendants understood and acknowledged in non-public communications that the principal reason for anyone to buy XRP was to speculate on it as an investment.

208. For example, Ripple Agent-3 stated in an internal document called the "XRP Distribution Framework," which he forwarded to at least one member of Ripple's Board of Directors on November 20, 2013, that "[s]peculators are speculating on Ripple Labs" and that, "[i]f you are holding xrp you should want [Ripple Labs] to retain xrp for business development." Ripple acknowledged not only that XRP holders were speculating on Ripple's ability to deploy XRP to develop its business, but also that Ripple's interests aligned with other XRP holders' interests.

209. Similarly, on December 7, 2015, Ripple requested that the issuer of a fund created to generate investor exposure to XRP (through XRP Ripple sold to the fund), disclose the risk that XRP could be deemed a security under the federal securities laws. Specifically, Ripple requested that the following language be added to the risk disclosures for the fund:

> The Ripple ecosystem's reliance on the efforts of Ripple Labs – the single largest holder of XRP – to promote and expand the ecosystem, creates greater risk that XRP might be deemed a security as compared to other virtual currencies and Ripple Labs might be deemed to be operating as an unregistered securities exchange, broker, or dealer under federal and State securities laws.

210. Similarly, in its official application to the NYDFS for XRP II in 2016, Ripple acknowledged that buyers were "purchasing XRP for speculative purposes."

211. Later, in July 2019, a Ripple senior vice president emailed the CEO of the United States branch of a digital asset trading firm with which Ripple sought to make XRP available for trading. In his email, the Ripple executive explained: "The primary use case for XRP today is speculative and the exchanges . . . are the main enabler of this use case."

212. Sophisticated investors agreed. For example, a hedge fund, to which Ripple sold XRP, explained to the fund's investors this economic reality in offering materials from March 2015: "The increase in XRP value is heavily dependent on the success of Ripple."

213. Consistent with its privately-stated understanding, Ripple publicly offered and sold XRP as an investment into a common enterprise that included Ripple's promises to undertake

significant entrepreneurial and managerial efforts, including to create a liquid market for XRP, which would in turn increase demand for XRP and therefore its price.

214. Starting in at least 2013 and through the Offering, Defendants made statements promoting XRP as described in the preceding paragraph in a variety of publicly available media, including Twitter, YouTube, major financial news networks, industry conferences, the XRP Chat, an online discussion forum and an informational posting about Ripple that it hosted on its website (but since deleted) called "Ripple Forum" and "Ripple Wiki," respectively, and the Markets Reports.

215. In fact, throughout the Offering, Ripple held itself out as the primary source of information on XRP. Ripple's website contained select information about how and where to buy XRP, XRP market data, and news and insights related to XRP. In the Markets Reports for the third quarter of 2019, Ripple made clear it would "take proactive steps" to address the "spread of misinformation" about Ripple's alleged "dumping" of XRP and to address the "fear, uncertainty, and doubt" about investing in XRP spread by others. Ripple thus held itself out as the legitimate source of information essential for investors, inviting them to rely on what Ripple chose to disclose.

216. Based on these representations, Ripple's actions, and the economic reality, XRP investors in the Offering had a reasonable expectation of profiting from Ripple's efforts to deploy investor funds to create a use for XRP and bring demand and value to their common enterprise.

A. Ripple Led Investors to Reasonably Expect that Ripple's and Its Agents' Entrepreneurial and Managerial Efforts Would Drive the Success or Failure of Ripple's XRP Projects

217. Defendants repeatedly stated publicly that they would undertake significant efforts to develop and foster "uses" for XRP, so that banks, financial intermediaries, or other specialized money transmitting businesses would want to buy it, including as alleged above in Section II. (The identity of the "users" to whom it would position XRP varied over the years as Ripple explored different strategies.)

218. Defendants also persistently stated publicly that—partly to achieve the goal of widespread XRP trading—they would take steps to create, promote, and protect the market for trading in XRP, such as managing the manner in which Ripple bought and sold XRP, and by persuading digital asset trading platforms to permit investors to buy and sell XRP. These statements led reasonable investors to expect to profit from Ripple's efforts on behalf of XRP.

1. Defendants Promised to Undertake Significant Efforts to Build Value for XRP

219. From the outset of the Offering, Defendants publicly promised significant, meaningful entrepreneurial efforts with respect to XRP.

220. In an April 14, 2014 interview published online, Larsen explained that Ripple was "helping to build in the Ripple protocol . . . the idea of an Internet-for-value exchange," and that Ripple saw "this as a SWIFT 2.0," referring to the established inter-bank payment network.

221. In approximately April 2014, Ripple created *"The Ripple Protocol: A Deep Dive for Financial Professionals"* (the "2014 Promotional Document"), which Ripple distributed publicly.

222. In the 2014 Promotional Document, Ripple purported to examine the "Sources of XRP Demand." Ripple stated that "Ripple Labs' business model is predicated on a belief that demand for XRP will increase (resulting in price appreciation) if the Ripple protocol becomes widely adopted." Ripple acknowledged that "[t]he Ripple network [was] still in its infancy and relatively unknown," but predicted "increased speculative interest, which may have significant impacts on price," if the Ripple network became more well-known or used, in which case Ripple concluded that it "expect[ed] the demand for XRP to be considerable."

223. In the 2014 Promotional Document, Ripple held itself out the key party who would make these efforts with respect to XRP and the Ripple protocol, including by promising to "distribute [certain XRP] to incent the participation of market makers, gateways and consumers to utilize the protocol," and highlighting Ripple's past "business development efforts." Ripple also

noted that it had recruited a "diverse set of talented individuals with experience in relevant technology and financial services companies" for these efforts and would enlist others to assist.

224. Ripple repeated these types of promotional statements throughout the Offering.

225. On June 3, 2016, Cryptographer-1 explained in the XRP Chat, in response to the question "if Ripple Failed, XRP died?", that he didn't "think it's likely XRP would succeed without us, though it's possible." But, he continued, while "there are significant technical obstacles to using XRP as a bridge or vehicle currency[,] . . . [o]ur XRP strategy is based on promoting it as a bridging currency . . . through various strategies including paying traders an incentive."

226. On January 21, 2017, Cryptographer-1 represented in the XRP Chat that Ripple was "heavily focused" on "building up an awesome payments infrastructure" using XRP and had "several strategies" to do so. Months later, on September 12, 2017, he posted on Reddit that Ripple had previously explained that it "will work to get XRP adopted for th[e] purpose" of serving as a "new intermediary asset" and noted "why that would be expected to create demand for XRP."

227. In an email to Ripple's equity shareholders, advisors, and others on June 5, 2017, Garlinghouse emphasized Ripple's efforts to increase XRP's liquidity and price through the XRP Escrow, among other things (with emphases added):

> [Ripple has] proactively addressed two key objections to XRP, . . . announcing our commitment to lock up the lion's share of our XRP in a cryptographically secured escrow account. . . . Despite a proven **track record of being good stewards for XRP**, we had continued to hear concerns in the market that Ripple could (hypothetically) sell our 61 billion XRP at any time **– a scenario that would certainly be bad for Ripple**! So with the decision to lock up 55 billion XRP in escrow, **we have given investors a predictable supply schedule** and removed what skeptics have suggested has been a barrier to broad XRP adoption. . . . **This recognition has translated into significant improvements in both the liquidity (trading volume) and price of XRP**. We saw nearly $6 billion in trading volume in May alone and XRP is now hovering around $0.30, **up approximately 500 percent in the last 30 days and over 5,000 percent from the beginning of 2017**! . . . In fact, factoring in the approx. $18 billion of XRP we own, Ripple is worth more than all but four US start-ups.

228. In the same email, Garlinghouse reminded Ripple's equity investors and advisors that Ripple remained "committed to making XRP the best digital asset for payments" and that XRP had "technical superiority compared to other digital assets."

229. Garlinghouse had made statements similar to these in an article posted on Ripple's website on May 16, 2017. A few months later, in a December 7, 2017 post on its website, Ripple, confirming the formation of the XRP Escrow, once more reiterated Garlinghouse's statements in the May 16, 2017 article and the June 5, 2017 email, described above.

230. In a December 14, 2017 public interview, Garlinghouse explained Ripple's market monitoring priorities as follows: "Priority one is definitely around volume. Priority two, I would say, is XRP liquidity. Making sure . . . we are doing everything we can to make the XRP ecosystem successful on a liquidity basis. Priority three which admittedly is kind of a newer priority and something we'll work on more in 2018, is investing in other use cases for the XRP Ledger."

231. In the Markets Report for the fourth quarter of 2017, Ripple stated that "it's clear Ripple's consistent steadfast support of XRP is a major advantage as the payments industry continues to seriously consider [XRP] as an alternate liquidity solution." A Ripple executive similarly explained his view in a Yahoo! Finance interview on approximately March 15, 2018, that "the activities of the software company create value in . . . [XRP]."

232. Also in the Markets Report for the fourth quarter of 2017, Ripple announced its upcoming intended efforts to "work towards the launch of institutional hedging instruments and custody solutions," which "are important to institutional adoption [*i.e.*, key forces in achieving liquidity and price increases] and thus are important components of our 2018 roadmap."

233. On September 11, 2017, Cryptographer-1 told public markets via a post on Reddit that, because "Ripple holds more than half the XRP in existence[,] . . . Ripple can justify spending $100 million dollars on something if it would be expected to increase the long term price of XRP by

a penny." Then, on November 17, 2017, he posted on Reddit about why Ripple had an incentive to continue these efforts and why it would continue these efforts: "[T]here is no rational reason why [Ripple] would not continue to execute [its] publicly announced strategy and do everything we can to maximize the price of XRP over at least the time it takes us to sell the XRP we have."

234. On January 17, 2018, Garlinghouse tweeted an article he said was "[a] good read on why fostering a healthy $XRP ecosystem is a top priority at @Ripple."

235. On February 17, 2020, Garlinghouse tied Ripple's efforts to create "use"-driven demand for XRP to a potential for an increase in XRP price, in an interview on the floor of the New York Stock Exchange in Manhattan (the "NYSE Interview").

236. In the NYSE Interview, Garlinghouse answered questions about the price of digital assets by predicting that markets would move "from that speculation that has driven the crypto market to utility." He stated that increased "use" of XRP had generated liquidity in the market for XRP and that "liquidity begets liquidity," such that market markers "see liquidity and they realize 'hey there is an opportunity there'." Tying this to Ripple's significant efforts, Garlinghouse promised: "Over the coming years . . . we Ripple are focused on driving utility from this asset and if we are successful at that we think that is good for the liquidity of the whole ecosystem."

2. Defendants Promised to Undertake Significant Efforts to Develop and Maintain a Public Market for XRP Investors to Resell XRP

237. Starting in at least 2014, Ripple also promised that it would undertake efforts to create, maintain, and protect secondary resale markets for XRP.

238. For example, starting in 2014, Ripple stated on its website: "[W]e will engage in distribution strategies that we expect will result in a stable or strengthening XRP exchange rate against other currencies." Years later, in announcing the XRP Escrow, Ripple reminded investors that it "engaged in distribution strategies that we expect will result in a strengthening XRP exchange rate against other currencies," touting its "proven [four-year] track record of doing just that."

239. In a February 19, 2014 public interview, Larsen explained that one of Ripple's "key roles is making sure that we distribute [XRP] as broadly in a way that adds as much utility and liquidity as we possibly can." He stated that he thought "our incentives are very well aligned . . . that for Ripple Labs to do well we have to do a very good job in protecting the value of XRP and the value of the network, and that really is the guiding principle here in our distribution of XRP."

240. In a May 16, 2017 article on Ripple's website, Garlinghouse reminded investors that, "[t]o build XRP liquidity, we have been mindful over the years about how we distribute XRP. Our goal in distributing XRP is to incentivize actions that build trust, utility and liquidity." He concluded that, to incentivize financial institutions, payment providers, and banks to "use" XRP (though none had up to that point), Ripple "remain[ed] committed to increasing XRP liquidity."

241. In the Markets Report for the second quarter of 2019, Ripple promised to "focus institutional sales on markets where the on-exchange liquidity for XRP is insufficient to meet institutional demand," which the report said was similar to what the company had done in 2017, purportedly leading to increased liquidity and "listings" on digital asset trading platforms in general.

242. In the Markets Report for the second quarter of 2020, Ripple explained that, as part of its "responsible role in the [XRP] liquidity process," it had begun purchasing XRP in the secondary market to ensure a "healthy, orderly XRP market."

243. Defendants engaged in many of these publicly-promised efforts with respect to XRP markets, as alleged in Section III, above.

3. Ripple Touted the Ability of Its Team to Succeed in Its Promised Efforts

244. In connection with the efforts Defendants promised the markets they would undertake, Ripple at times highlighted the experience, expertise, and abilities of the "team" it had assembled, which included Ripple employees, business partners, and other agents.

245. In 2013, Ripple Agent-1 explained in the Ripple Forum that Ripple's fundraising efforts through selling XRP "allows Ripple Labs to have a spectacularly skilled team to develop and promote the Ripple protocol and network."

246. In a Reddit post in 2017, Cryptographer-1 was asked to explain if there was a risk that "XRP Will Go to 0." He explained "the biggest risks," from his perspective, included that Ripple's executives would stop working on XRP and that "[s]omeone else does almost exactly the same thing Ripple does, but does it better." He noted that this last risk was "mitigated by the fact that Ripple has such talented people and has a lead."

4. Ripple Publicly Touted the Efforts That It Did Actually Undertake

247. During the Offering, not only did Ripple *promise* efforts that could lead to the increase in value of XRP, it actually *made and touted* extensive entrepreneurial and managerial efforts—made with proceeds from the Offering—to the market.

248. In its 2016 "Year In Review" summary, posted on its website on December 28, 2016, Ripple reminded readers of its January 2016 announcement of a joint venture to distribute "Ripple's solutions" in certain countries and a February report on "how the use of Ripple's enterprise solution and XRP can significantly impact a bank's operational costs." Although Ripple had not sold a single XRP to any "user," Ripple commented that "[g]ood news for XRP kept coming later in the spring" with the announcement of a partnership with a facility to trade in XRP derivatives.

249. In the first Markets Report, published on January 24, 2017, Ripple touted its announcement of XRP investors' ability to buy and sell XRP on a new digital asset trading platform as "part of a continued effort to expand the XRP ecosystem."

250. On February 15, 2017, Ripple Agent-2 tweeted a link to an article, posted on a digital asset discussion blog, about Ripple's efforts to enlist companies to assist in its managerial efforts as

to XRP. The article discussed Ripple's efforts to select a partner to help it build "functionality for XRP" and directed readers to Ripple's website on "How to Buy XRP."

251. As alleged above in Sections III and IV.A.1, Ripple and Garlinghouse made many statements in connection with the announcement of the XRP Escrow, reminding investors that Ripple had been a good "steward" of XRP, purportedly based on the ways Ripple had chosen to make its own market sales of XRP.

252. In an interview on Bloomberg News Network ("Bloomberg News") in approximately December 2017, Garlinghouse explained that XRP's price had risen because Ripple was "solving a real problem . . . a multi-trillion dollar problem around cross-border payments . . . and people have gotten excited." Pressed about "speculation" in the digital asset space and XRP investor "expectations" from Ripple, Garlinghouse explained:

> [T]he value of digital assets will be driven by their utility, if they're solving a real problem . . . then there will be demand for the tokens, the price of the tokens will go up. For XRP, we've seen because it's . . . something that can really reduce the friction, and we're talking about a multi-trillion dollar problem . . . yes, there's going to be demand for that, when you have fixed supply . . . and you see increase in demand, prices go up.

253. In a CNBC interview on March 7, 2018, Garlinghouse reminded investors that "[t]here's no party more interested in the success of the XRP ecosystem than Ripple . . . because we own a lot of XRP." Thus, he continued, Ripple had "invested in venture funds . . . in hedge funds . . . in companies, [and] . . . partnered with payment providers [and] . . . market makers, in order to make sure that XRP is the most useful asset out there for solving a cross border payment problem."

254. On April 11, 2018, Ripple tweeted from the handle @Ripple that it "had invested $25 million in XRP to Blockchain Capital Parallel IV, LP" to "support and develop additional [XRP] use cases beyond payments." Ripple Agent-3 similarly tweeted: "Ripple's $25 million investment in @blockchaincap's new fund is the first and not the last contribution to ventures that further develop the #blockchain and $XRP ecosystems."

255. At various times, Ripple publicly touted that it was making certain of the XRP distributions through xPring or RippleWorks, further making clear to potential investors that Ripple was enlisting the efforts of persons other than investors with respect to XRP.

5. Economic Reality Dictates that XRP Purchasers Have No Choice But to Rely on Ripple's Efforts for the Success or Failure of Their Investment

256. Economic reality has also led reasonable investors to expect that Ripple and its agents will undertake significant efforts to increase the price of XRP. Reasonable investors accordingly understanding that Ripple has the economic incentive and capacity to undertake efforts to promote XRP and the XRP Ledger, which would serve Ripple's economic interest and that of all XRP owners equally.

257. Indeed, the XRP market capitalization as of last week (approximately $58 billion) and the value of Ripple's XRP holdings (approximately $28 billion) each far exceed the value of the one product—ODL—that "uses" XRP (which "use" is not market-driven, but subsidized by Ripple).

258. The economic reality is that reasonable investors are speculating that Ripple has the incentive and potential to create demand for XRP. XRP investors are betting that Ripple may yet solve Garlinghouse's "trillion-dollar problem," and they will profit as a result.

259. In contrast to Ripple, investors in XRP cannot take most or any of the steps that Ripple has taken to grow the XRP ecosystem and increase demand for XRP. Most, if not all, XRP investors simply lack the technical expertise and the resources to do so.

260. XRP investors are not in any position to, for example, undertake various, complex, expensive, and all-encompassing strategies about when or how to sell XRP into the markets to protect XRP's price, volume, and liquidity—as Ripple has done in a purported attempt to foster adoption of XRP. Nor are XRP investors in any position to increase significantly "demand" or "value" for XRP by developing a "use" for the token through entrepreneurial efforts—at least not

without Ripple's support. In other words, not only are Ripple's touted efforts with respect to XRP significant, they are essential to the success or failure of the enterprise.

261. Investors in XRP do not exercise any control or authority over how Offering proceeds have been or will be spent. Ripple possesses sole discretion to decide how to do so.

262. Because certain Ripple executives publicize that they hold XRP, and some (including Garlinghouse) state that they hold it as an investment, it is reasonable for a holder of XRP to expect these individuals to undertake efforts to increase the value and price of XRP.

263. Defendants' statements and actions and the economic reality of Ripple's relationship to XRP and of Ripple's payments to third parties to help it achieve widespread trading of XRP has led and will continue to lead reasonable investors to expect Ripple and its cadre of experts to undertake significant and essential technical, managerial, and entrepreneurial efforts on their behalf.

B. Purchasers of XRP Invested into a Common Enterprise

264. Investors who purchased XRP in the Offering invested into a common enterprise with other XRP purchasers, as well as with Ripple.

265. Because XRP is fungible, the fortunes of XRP purchasers were and are tied to one another, and each depend on the success of Ripple's XRP Strategy. In other words, Ripple's success or failure in propelling trading of XRP drives demand for XRP, which will dictate investors' profits (recognized in increased prices at which they could sell XRP) or losses.

266. XRP investors stand to profit equally if XRP's popularity and price increase, and no investor will be entitled to a higher proportion of price increases. In other words, the price of XRP rises and falls for XRP investors together and equally for all investors.

267. Moreover, Ripple pooled the funds it raised in the Offering and used them to fund its operations, including to finance building out potential "use" cases for XRP, paying others to assist it in developing a "use" case, constructing the digital platform it promoted, and compensating

executives recruited for these purposes. Ripple did not segregate or separately manage proceeds from different XRP purchasers in the Offering. The nature of XRP itself made it the common thread among Ripple, its management, and all other XRP holders.

268. Defendants recognized and repeatedly emphasized these common interests to prospective investors, including by explaining to the market that Ripple used proceeds from XRP sales to fund its operations and that Ripple wanted XRP to succeed.

269. For example, from the outset of Ripple's operations, Ripple Agent-1 and Cryptographer-1 made publicly clear that Ripple would sell XRP to raise funds for one common enterprise: to fund its operations, as described below.

270. On March 10, 2013, Cryptographer-1 explained in the Ripple Forum on Ripple's website that Ripple's "source of revenue is the sale of XRP."

271. A few months later, on August 28, 2013, Ripple Agent-1 echoed that sentiment, stating that Ripple "wholesales XRP to fund operations."

272. On September 2, 2013, Ripple Agent-1 again noted on the Ripple Forum that Ripple "is funded by investments and the sale of XRP."

273. Similarly, the next year, in its 2014 Promotional Document, Ripple explained its "plans to retain 25% of all XRP issued to fund operations (and hopefully turn a profit)."

274. This public disclosure echoed Larsen's explanation, in an online interview dated April 14, 2014, that Ripple was "keeping 25% of . . . XRP . . . to cover the bills." When asked about Ripple's business model, Larsen reminded readers that Ripple was "keeping 25% of those XRP, and using the rest of it to incent market makers, gateways, consumers to come onto the protocol."

275. From at least 2014 through at least 2017, Ripple made a similar representation in the Ripple Wiki: "Ripple Labs sells XRP to fund its operations and promote the network. This allows Ripple Labs to have a spectacularly skilled team to develope [sic] and promote the Ripple protocol."

276. Ripple also made clear that the common interest was not just any interest, but a specific interest in XRP's price increasing, as Ripple's (significant) XRP holdings were essentially its only asset. For example, in his Ripple Forum post from September 2013, Ripple Agent-1 stated that Ripple's "business model is to hold XRP in the hope that it will have value."

277. At times, Ripple used the terms "value" and "price" interchangeably. In one early promotional document distributed to Ripple investors and potential partners, Ripple asked whether digital assets could have "value" above a graph showing increases in the price of bitcoin, suggesting that XRP could have a similar increase. And, on approximately December 12, 2017, Garlinghouse publicly responded to a question on Twitter about whether the "price of XRP" was "inconsequential or something you care about as a primary driver of business." Garlinghouse said: "[A] healthy $XRP market and healthy $XRP ecosystem is CRITICALLY important to me. And it is indeed a primary driver. Long-term price will reflect success driving institutional use of $XRP."

278. In 2014, the Promotional Document explained Ripple's view that, "as demand for XRP grows, the value of XRP should appreciate" and that, therefore, "Ripple Labs believes that its incentives are aligned with those of protocol's users."

279. Cryptographer-1 has repeatedly and publicly expressed that Ripple's incentives are aligned with other XRP holders'—specifically, as to increasing Ripple's price—because Ripple "holds a huge pile of XRP," including in a statement he made on XRP Chat on May 25, 2017.

280. Garlinghouse in particular frequently encouraged investors to view their economic interests as aligned with Ripple's.

281. As alleged above, on January 17, 2018, Garlinghouse tweeted an article discussing Ripple's remaining supply of XRP. Garlinghouse's tweet noted that Ripple was not selling all of its remaining XRP supply, and that the article was "[a] good read on why fostering a healthy $XRP ecosystem is a top priority at @Ripple."

282. The following month, in an interview on February 11, 2018, Garlinghouse acknowledged: "Ripple the company, as the owner of 61% of the tokens today, is the most interested party in the success of the XRP ecosystem."

283. Similarly, on March 7, 2018 in a CNBC interview, Garlinghouse stated: "There's no party more interested in the success of the XRP ecosystem than Ripple. We want that to be massively successful because we own a lot of XRP."

284. Garlinghouse publicly reiterated sentiments similar to these on March 7, 2018 in an interview with the Financial Times and again on August 13, 2020 in an interview with a major financial publication, where he said: "We are a capitalist, we own a lot of XRP. So do I care about the overall XRP market? 100 per cent."

285. On October 8, 2019 in a speech at the Economic Club of New York in Manhattan (the "Economic Club Speech"), Garlinghouse acknowledged: "Ripple owns . . . about 55% of all XRP. So clearly we're very interested in the health and success of that [XRP] ecosystem." Asked about Ripple's "revenue model," he explained that while Ripple has software it sells, "it owns a lot of this digital asset" and that "[a]nything we do that is good for that digital asset is good for us."

286. Currently, Ripple continues to make clear on its website that it holds at least 54 billion XRP, making it by far the largest single holder of the asset.

287. The Legal Memos focused on this very fact—the existence of an identifiable actor who held itself out as responsible for making efforts with respect to XRP—in distinguishing XRP from bitcoin for purposes of the federal securities laws. The Legal Memos noted that, unlike with bitcoin, there was "a specific entity," Ripple, "which is responsible for the distribution of [XRP] and the promotion and marketing functions of the Ripple Network."

288. At least one Ripple equity shareholder ("Equity Investor A"), a sophisticated investor, understood this distinction. In an internal email on April 26, 2018, an Equity Investor A

employee wondered whether the XRP Ledger was subject to a "51% attack" (a threat to the status of the digital ledger), as he perceived the bitcoin blockchain to be. He concluded that it was "more of a longer-term question given the current incentives of the stake holders," meaning that Ripple had incentives to protect the XRP Ledger. Another employee agreed: "That has always been the point. Ripple is controlled by 1 entity rather than through a distributed entity like Bitcoin."

C. Ripple Led Investors to Reasonably Expect a Profit from Their Investment Derived from Defendants' Efforts

289. Ripple also led investors to reasonably expect that they could reap a profit from their investment into XRP, derived from Ripple's and its agents' efforts into their common enterprise. Ripple did so by, among other things, stating that Ripple's efforts sought to increase "demand" for XRP; assuring investors that Ripple would take steps to protect the market for XRP, including by fostering a readily available XRP trading market; highlighting XRP price increases and at times tying them to Ripple's efforts; and selling XRP to certain institutional investors at discounted prices.

290. Ripple made many of these statements in the Markets Reports, which typically included a segment entitled "Market Commentary" for XRP, in which Ripple highlighted XRP price increases and at times sought to persuade investors that Ripple's efforts lay behind such rallies.

1. Defendants' Publicly Stated Goal Was to Increase "Demand" for XRP Through Their Entrepreneurial and Managerial Efforts

291. Throughout the Offering, as alleged in Section IV.A.1, above, Defendants repeatedly told investors that Ripple's XRP-related efforts were meant to spur "demand" for XRP. Ripple at times even explicitly tied the hope for an increase in demand to what any reasonable investor would understand an increase in demand to entail: an increase in XRP's market price.

292. Ripple made other such statements encouraging investors to expect to profit from Ripple's efforts to create institutional demand for XRP. For example, in response to questions about XRP's declining market price during a March 14, 2018 interview, Garlinghouse explained that,

if Ripple was "successful in building out the project of xCurrent and expanding the number of users around xRapid, the price of XRP will take care of itself over a 3 to 5 year period."

2. Ripple and Garlinghouse Assured Investors Ripple Would Protect the Trading Markets for XRP

293. Ripple executives confirmed in internal emails that one of Ripple's goals in announcing the XRP Escrow was to encourage the price of XRP to go up. In a May 7, 2017 "XRP Markets Update" to certain Ripple executives, Ripple Agent-2 noted that "XRP activity in the last few days has been impressive, to say the least," and that this activity "seems to be driven by speculation around the lockup"; and highlighted the 50% "rall[y]" in XRP's price after Ripple Agent-2 publicly mentioned the possibility of the XRP Escrow for the first time.

294. Ripple sought to assure investors that they could trust Ripple to protect the XRP trading markets. Ripple repeatedly stated that it expected its XRP "distribution strategies" to strengthen its price vis-à-vis other assets and told investors it was establishing the XRP Escrow to remove uncertainty over the supply of XRP in the market (which Ripple viewed as depressing XRP's price). As Garlinghouse explained in a December 14, 2017 interview posted on Ripple's official YouTube channel ("Ripple's YouTube Channel"), Ripple established the XRP Escrow to "remove the perception that there's a risk" regarding XRP's supply, and "[t]he market reacted well to that."

3. Ripple and Garlinghouse Touted Investors' Ability to Easily Buy and Sell XRP

295. Related to Ripple's touting of its efforts to protect the trading markets for XRP, Ripple touted the ability of investors to buy and sell XRP on digital asset trading platforms (none of which had anything to do with "using" XRP in any way other than as a speculative vehicle).

296. Ripple undertook extensive efforts—starting in at least late 2015—to persuade digital asset trading companies to permit investors to buy and sell XRP on their platforms, especially those that would make XRP tradable against the USD, as alleged in Section III.B.

297. On May 18, 2017, Ripple Agent-3 tweeted: "Kraken [a digital asset trading platform] Introduces New Fiat Pairs for XRP Trading! USD, JPY, CAD, EUR @Ripple."

298. In the Markets Report for the first quarter of 2017 Ripple touted another platform's "successful launch of XRP for USD, EUR, and BTC currency pairs" as a "bright spot" for XRP.

299. In a follow-up to his June 5, 2017 email described above, Garlinghouse demonstrated that he understood that announcements and actions regarding the increase in XRP trading liquidity could lead to price appreciation for XRP. In response to a question by an individual about what was driving the "staggering appreciation" of prices in the digital asset space, Garlinghouse responded, among other things, that "for XRP more specifically," Ripple "announcements about new exchanges listing XRP . . . continues to create tailwinds," and that Ripple would continue making these efforts, "which should hopefully drive some tailwinds."

300. On December 14, 2017, Garlinghouse stated on Ripple's YouTube Channel: "Today XRP is listed at about fifty exchanges around the world. Clearly we want XRP to be listed at more exchanges that are reputable and regulated in those appropriate markets. So it is a very high priority for us to be listed more broadly but you know we're going to continue working on that with partners around the globe."

301. Ripple itself publicly noted the importance of XRP being traded on digital asset trading platforms. In articles published on its website on December 21, 2017 and January 18, 2018, Ripple noted: "[I]t's a top priority for Ripple to have XRP listed on top digital asset exchanges. . . . Ripple has dedicated resources to the initiatives so you can expect ongoing progress."

302. That day, Ripple also tweeted about "XRP Available on 50+ Exchanges."

4. Ripple and Garlinghouse Touted XRP as an Investment, Including by Highlighting XRP Price Increases

303. Ripple and Garlinghouse also encouraged reasonable investors to view the purchase of XRP as something from which they could profit by persistently touting increases in XRP's price.

304. In a January 18, 2017 email, Garlinghouse told an XRP investor that "XRP had a good year in 2016—with significant increases in price and volume—which in turn has increased investor interest."

305. On March 24, 2017, Ripple tweeted: "The price of #XRP continues to surge showing that people are looking for #bitcoin alternatives."

306. On May 3, 2017, Ripple tweeted: "#Ripple adoption is sparking interest in XRP 'which has had an impressive rally in the last two months' via @Nasdaq."

307. Two days later, on May 5, 2017, Cryptographer-1 tweeted, along with a picture of champagne, that he "finally got to drink the champagne [he was] reserving for #XRP at $0.10."

308. On June 29, 2017, Ripple tweeted a clip of an interview Garlinghouse gave on CNBC with the caption: "#XRP – up 4000% this year – has shown the market favors a real use case for #digitalassets." Garlinghouse also predicted that "digital assets broadly are in a position to be more useful than gold as a value transfer" and described XRP as "solving a real-world use case."

309. In the Markets Report for the third quarter of 2017, published October 19, 2017, Ripple touted the fact that anticipation surrounding Ripple's annual conference "had spurred a meaningful spike in XRP" and that this rise in price lacked any "corresponding rally in [bitcoin] and [the digital asset referred to as ETH]," noting that XRP's price was "at times overwhelmingly independent" from that of bitcoin and ETH.

310. On December 7, 2017, when the XRP Escrow began, Ripple tweeted: "55B $XRP is now in escrow. Interested in what this means for $XRP markets?" Garlinghouse similarly tweeted: "Boom! 55B $XRP now in escrow. Good for supply predictability and trusted, healthy $XRP markets. Glad to finally let this #cryptokitty out of the bag!"

311. A week later, on December 12, 2017, Garlinghouse retweeted Institutional Investor C's tweet: "Wow, XRP at all time high! Forget bitcoin, we're all in on XRP!"

312. Later that month, on December 22, 2017, Garlinghouse tweeted an article discussing how "Ripple Soars at Year End," with the caption "I'll let the headline speak for itself. $xrp."

313. Ripple did not limit its touting of XRP purchases as a potential means for investors to profit only to increases in XRP prices in the abstract. Frequently, Ripple explicitly tied actual or potential XRP investment returns to Ripple's completed or upcoming efforts—both with respect to developing demand for XRP and to protecting the XRP markets themselves.

314. In connection with a significant rise in the price of XRP on March 23, 2017, Ripple explained in the Markets Report for the first quarter of 2017 that "key [Ripple] developments may have had an impact[,]" including statements by Ripple "about its commitment to XRP and the Ripple Consensus Ledger (RCL) as part of its long-term strategy."

315. In the Markets Report for the second quarter of 2017, Ripple noted that various "XRP developments," including the XRP Escrow, were "instrumental in helping to drive XRP interest and volume," and highlighted Ripple's "clear plans . . . to address top concerns about XRP" in the following quarter. Ripple also stated that "[t]here were a number of significant announcements and events which clearly contributed to XRP's incredible second quarter," reflected by a "stunning QoQ [price] increase of 1[,]159%" and "YTD [year to date] growth of 3[,]977%."

316. Garlinghouse himself was a particularly persistent spokesperson for Ripple's efforts to market XRP as an investment from which investors could potentially profit. While he was selling millions of XRP, Garlinghouse frequently told investors that he was invested in XRP, and that he was bullish on the investment. Throughout the Offering and as XRP's price fluctuated, he also encouraged investors to be patient and look at the price of XRP on a longer time horizon.

317. For example, in the June 5, 2017 email described above, Garlinghouse noted that Ripple's efforts to develop uses for XRP and the XRP Escrow had "translated into significant

improvements in both the liquidity (trading volume) and price of XRP," which was "up approximately 500 percent in the last 30 days and over 5,000 percent from the beginning of 2017!"

318. In a follow-up to that email, an individual asked Garlinghouse to explain "what drives the staggering appreciation and/or volatility" in the "cryptocurrency markets." Garlinghouse responded with two reasons he described as "macro" reasons, then stated: "For XRP specifically, . . . as Ripple has done well in announcing customers – that has driven market interest in buying XRP as a speculative investment." He then gave examples of such Ripple announcements that were "catalysts to this market rally" or that "furthered the rally."

319. Later, in a September 11, 2017 interview on CNBC, Garlinghouse noted Ripple's supposed success as a company and stated: "I think that's increased the value of XRP."

320. The following month, during an October 18, 2017, question-and-answer session at a Ripple-sponsored conference, which was posted on Ripple's YouTube Channel, Garlinghouse repeated a statement he repeated frequently in similar terms: that he was "not focused on the price of XRP over 3 days, or 3 weeks, or 3 months" but, rather, "over 3 years and five years." He also stated, in response to a question about XRP's price, that he had "no qualms saying definitively if we continue to drive the success we're driving, we're going to drive a massive amount of demand for XRP, because we're solving a multi-trillion dollar problem."

321. Similarly, in a November 2017 interview with CNBC, Garlinghouse noted: "On a personal basis, I'm long BTC, Bitcoin. I guess technically I'm long Bitcoin Cash. But I'm also long XRP." He repeated the sentiment the following month, in a December 14, 2017 interview with Bloomberg News. When asked if he invested in XRP, he said: "I'm long XRP, I'm very, very long XRP as a percentage of my personal . . . balance sheet" (though he had already sold at least 67 million XRP). Later, he reiterated, "I remain very, very, very long XRP, . . . I'm on the HODL side," referring to a digital asset industry term meaning to be long on an asset for long-term gains.

322. In a March 12, 2018 interview with Bloomberg News, Garlinghouse, noting the potential market capitalization of XRP into the trillions of dollars, stated: "[W]e have found that part of the reason why XRP has performed well, is because people realize. . . if we work with the system to solve this problem and we can solve that problem at scale, a problem measured in the trillions of dollars, then there is a lot of opportunity to create value in XRP." Garlinghouse also speculated in the December 14, 2017 interview that, if a company created "utility" for a digital asset like XRP, "then there will be demand for the tokens, [and] the price of the tokens will go up."

323. In the NYSE Interview, when the interviewer asked, "[s]o, XRP, is that a good investment?" and then insisted, "What's the investment case [for XRP]?", Garlinghouse responded that "the value of any digital asset in the long-term will be derived from the utility it delivers," presumably from Ripple's efforts, as the company had repeatedly emphasized to investors.

5. Ripple's Privately-Stated Goal Was to Increase Speculation on the Price of XRP

324. As these public statements show, speculative investment in XRP was precisely what Ripple wanted and promoted—it needed speculative investment for its own stated strategy to be successful and to increase the value of and monetize its XRP holdings.

325. Ripple explicitly stated these goals internally, including in documents describing one of the reasons to establish the XRP Escrow as securing speculative liquidity, with the hopes that it would lead to "immediate increase in volume and price appreciation."

326. Ripple Agent-3's March 31, 2017 "Q2 [second quarter] XRP Plan Update" email to Garlinghouse acknowledged that Ripple was taking most of the steps described above to encourage speculative investment in XRP. He also told Garlinghouse that "[t]he goal [was] to drive XRP speculative trading volume" and that the "tactics" Ripple planned to undertake to do so included "escrow announcement," "[s]ign[ing] exchanges," putting out information into the market to "tak[e] on skeptics," and announcing business deals to "[s]park speculation about potential partnerships."

6. *XRP's Characteristics—as Constructed by Ripple—Reasonably Fueled Purchasers' Expectations of Profiting*

327. The very nature of XRP in the market—as constructed and promoted by Ripple—compels reasonable XRP purchasers to view XRP as an investment.

328. Except for certain trading volume limitations, XRP is freely transferable or tradeable without restrictions the moment it is purchased, and it was offered broadly and widely to all potential purchasers, not just those who might be reasonably expected to "use" XRP.

329. Ripple made certain Institutional Sales of XRP at discounted priced, leading purchasers to reasonably expect to profit on their resale of XRP into the public markets.

330. Moreover, the value of Ripple's current holdings of XRP (approximately $28 billion as of last week) and of XRP's total market capitalization of approximately $58 billion—given that, as Garlinghouse has publicly stated, Ripple "would not be profitable or cash flow positive" without selling XRP—demonstrates that XRP investors are speculating that Ripple will achieve its stated goals with respect to XRP. In other words, market participants, when they buy XRP, are speculating that Ripple's economic incentives and its promises with respect to XRP will lead it to successfully solve the "trillion-dollar problem" that will increase demand for XRP.

331. As Garlinghouse summed it up in a December 29, 2017 interview with Bloomberg News, XRP's current market value and Ripple's holdings of XRP "gives [them] a huge strategic asset to go invest in and accelerate the vision we see for an internet of value. . . . For me this is all . . . about an opportunity to participate and accelerate a vision we've had for some time."

V. <u>In the Offering, Ripple Did Not Sell XRP for "Use" or as "Currency"</u>

A. No Significant Non-Investment "Use" for XRP Exists, and Ripple Did Not Sell XRP in the Offering for "Use"

332. The first potential use that Defendants touted for XRP—to serve as a "universal digital asset" and/or for banks to transfer money—never materialized.

333. Not until approximately mid-2018 did Ripple first begin earnestly testing ODL—to date its only product that permits XRP use for any purpose. The potential "users" of ODL that Ripple is targeting are money transmitters.

334. ODL involves a transaction in which a money transmitter in a sender's jurisdiction converts fiat currency into XRP, transfers the XRP to a recipient's jurisdiction, and converts the XRP into the fiat currency of that locale. Typically, instead of holding XRP directly, money transmitters who may use ODL would rely on market makers in the sender's and recipient's jurisdictions to trade in and out of XRP in about ninety seconds or less.

335. ODL is an enterprise-grade software product intended for managing a financial institution's daily and long-term treasury operations—it is not intended for individual use.

336. On June 21, 2018, Garlinghouse explained in a public speech that nobody was using XRP to effect cross-border transactions as of that date. Instead, he said that Ripple "expect[ed] this year for at least one bank to use XRP in their payment flows, to use xRapid [ODL]."

337. Ripple did not commercially launch ODL until October 2018.

338. Since its launch, ODL has gained very little traction, in part due to certain costs of using the platform. From October 2018 through July 26, 2020, only fifteen money transmitters (none of which are banks) signed on to potentially use ODL, and ODL transactions comprised no more than 1.6% of XRP's trading volume during any one quarter (and often substantially less).

339. Much of the onboarding onto ODL was not organic or market-driven. Rather, it was subsidized by Ripple. Though Ripple touts ODL as a cheaper alternative to traditional payment rails, at least one money transmitter (the "Money Transmitter") found it to be much more expensive and therefore not a product it wished to use without significant compensation from Ripple.

340. Between early 2019 and July 2020, the "Money Transmitter" conducted the overwhelming majority of XRP trading volume in connection with ODL. Ripple had to pay the

Money Transmitter significant financial compensation—often paid in XRP—in exchange for the Money Transmitter's agreement to help Ripple increase volume on ODL.[4]

341. Specifically, from 2019 through June 2020, Ripple paid the Money Transmitter 200 million XRP, which the Money Transmitter immediately monetized by selling XRP into the public market, typically on the very days it received XRP from Ripple. The Money Transmitter publicly disclosed earning over $52 million in fees and incentives from Ripple through September 2020.

342. The Money Transmitter became yet another conduit for Ripple's unregistered XRP sales into the market, with Ripple receiving the added benefit that it could tout its inorganic XRP "use" and trading volume for XRP. The Money Transmitter has served that principal purpose for Ripple in exchange for significant financial compensation.

343. Ripple and Garlinghouse did not disclose to XRP investors or the public the full extent of incentives that Ripple provided to the Money Transmitter in return for its assistance in increasing XRP trading volume.

344. For example, in a September 12, 2019 interview on CNN, Garlinghouse refuted speculation that Ripple was manufacturing demand for ODL and claimed: "When [the Money Transmitter] is moving money from U.S. dollar to Mexican peso, they're buying [XRP] at market. There's no special sweetheart deal there." While the Money Transmitter was buying XRP in the market at current market prices (not from Ripple), Garlinghouse did not disclose that Ripple was paying the Money Transmitter significant financial incentives to do so.

345. Even after ODL's launch, Ripple publicly acknowledged in July 2019 that XRP has no significant use beyond investment, as alleged in paragraph 211 above.

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4 In June and November 2019, Ripple also made equity investments in the Money Transmitter totaling $50 million in exchange for its stock and a seat on its Board of Directors. Ripple currently holds approximately 9% of the Money Transmitter's publicly-traded stock.

346. Though it had started selling XRP to public investors in 2013, Ripple announced, for the first time in its history in 2020, that it began selling XRP directly to money transmitters specifically for effecting money transfers through ODL.

347. From May through mid-August 2020, Ripple sold XRP to two other money transmitters for use in ODL for total proceeds of approximately $70 million dollars. In order to effectuate the ODL transaction, the money transmitters then immediately resold those XRP into the public markets, to individuals and entities that had no "use" for XRP.

348. Ripple earns only *de minimis* fees from the ODL platform. Instead, Garlinghouse views "the value creation of xRapid [ODL] as driving the liquidity in the XRP markets."

349. Throughout the Offering, Defendants did not target sales of XRP to people to whom XRP's undeveloped, potential future "uses" could reasonably be expected to appeal. For example, Defendants did not market XRP in the Offering to entities that might "use" XRP as a bridge currency or even to individuals who had a need for an alternative to fiat currency.

350. Throughout the Offering, Defendants did not restrict sales of XRP to purchasers who would actually "use" XRP as a medium to execute cross-border transactions. Defendants offered, sold, and distributed XRP to investors worldwide, in any quantities and at various prices.

351. Throughout the Offering, Defendants offered, sold, and distributed XRP in amounts that far exceeded any potential "use" of XRP as a medium to transfer value.

352. Defendants did not restrict the XRP they sold to money transmitters for use in ODL transactions. Rather, a necessary final step in any ODL transaction includes selling the XRP into the market.

B. XRP Are Not "Currency" Under the Federal Securities Laws

353. In May 2015, Ripple and XRP II agreed (i) to settle charges brought by the United States Department of Justice and FinCEN for failing to register as a "Money Services Business"

under the Bank Secrecy Act and (ii) to comply with other regulatory requirements with respect to Ripple's XRP sales, which the settlement called "virtual currency."

354. Consequently, Ripple has at times suggested that XRP are not securities, but instead exempt from the Securities Act altogether as "currencies."

355. XRP is not "currency" under the federal securities laws.[5]

356. XRP has not been designated as legal tender in any jurisdiction. XRP is not issued by, nor is backed by the full faith and credit of, any country, national government, central bank, or other central monetary authority. A "native currency" that operates, for example, on Ripple's decentralized network of blockchain technology is a specialized instrument for a particular computer network, not legal tender. Similarly, using XRP as a "bridge" between two real, fiat currencies does not bestow legal tender status on XRP.

357. Moreover, Ripple has never offered or sold XRP as "currency," as that term is used in the federal securities laws. Throughout the Offering, Ripple never restricted offers or sales of XRP solely to purchasers who had a need for alternatives to traditional, fiat currencies, nor did Ripple promote XRP as an instrument for consumers to purchase goods or services.

358. Instead, Ripple and its executives repeatedly publicly disclaimed that XRP was "currency" and tried to dissuade investors from thinking about XRP as "currency."

359. For example, in June 2016, Cryptographer-1 explained in a public XRP Chat post: "We do not plan to encourage use of XRP as an alternative to Bitcoin or as a direct payment method at this time."

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[5] FinCEN has repeatedly reiterated its view that "virtual currency" that may be converted for traditional fiat currencies may still be subject to the federal securities laws "regardless of other intended purposes" for the convertible virtual currency. *See, e.g.*, FinCEN Guidance, Application of FinCEN's Regulations to Certain Business Models Involving Convertible Virtual Currencies, FIN-2019-G001 (May 9, 2019) *available at* https://www.fincen.gov/sites/default/files/2019-05/FinCEN%20Guidance%20CVC%20FINAL%20508.pdf.

360. Two years later, in a press conference on March 14, 2018, Garlinghouse stated:

> I almost never use the expression cryptocurrency. And the reason is today, these aren't currencies. I can't go down to Starbucks and buy a coffee with Bitcoin. I can't buy . . . coffee with XRP. . . . Currencies, traditionally, are something you can use to transact efficiently and broadly. Very few people, even in the crypto community have used the, you know, Bitcoin or XRP to buy something.

361. Similarly, in Garlinghouse's Economic Club Speech in October 2019, a moderator asked Garlinghouse for an example of using XRP "to buy or sell something." Garlinghouse responded: "XRP in my judgment, and really any crypto, I don't think the use case is a consumer use case today. . . . [W]hen people talk about using crypto for consumer use case I go to the 'well what problem are we trying to solve?' . . . [I]n first world countries like the United States . . . I don't see the consumer use for crypto any time soon," or even for "95% of global GDP."

362. Ripple's own current internal policies treat XRP as securities—not currency.

363. Since at least 2015, Ripple's internal "Code of Conduct" has directed Ripple "[i]nsiders" not to "buy, sell, recommend or trade XRP" in possession of "information about Ripple or the Ripple protocol that has not been publicly announced, and which might reasonably affect the decision to buy or sell XRP"—effectively, a prohibition against insider trading, applicable to securities under the federal securities laws.

364. Similarly, since at least July 2019, Ripple has banned certain members of its "leadership team" from entering into a "trading plan" for XRP "on the basis of information a reasonable person would consider important in making his or her decision to purchase, hold or sell XRP"—another implicit reference to rules governing insider trading.

365. Even if some country were to recognize XRP as fiat "currency" at some point in the future, that would result from Defendants' significant entrepreneurial and managerial efforts to date (and likely in the future), on which public investors expecting profit relied when making an investment of money into Defendants' common enterprise.

VI. Defendants Failed to Register the Offering with the SEC

366. Defendants used interstate commerce for the Offering by, among other things, promoting investments in XRP in emails, interviews disseminated to the public through television and the Internet, and publicly available social media applications; and by effecting transfers of XRP and of the Offering proceeds through global digital asset trading platforms.

367. Defendants have never filed a registration statement with the SEC with respect to any XRP they have offered or sold or intend to offer or sell, and no registration statement has ever been in effect with respect to any offers or sales of XRP.

368. Ripple's public disclosures contained selective or no information about Ripple's financial history, audited financial statements, management discussion and analysis of its financial condition and results of operations, and ability to generate profits, and no information about Ripple's ability to develop XRP into a substitute for certain financial transactions. Purchasers who bought or received XRP have not received any documents containing information about Ripple's operations, financial condition, or other factors relevant in considering whether to invest in XRP. XRP investors have also been deprived of information about how Ripple's executives are being compensated as a result of the Offering or about Ripple's use of funds derived from the sale of XRP. Nor have investors received complete information about any steps Ripple is taking to incentivize financial institutions to adopt XRP for use in a payment system, including the extent and nature of incentive payments made to businesses Ripple touts as market-driven "users" of its products, and about steps that Ripple takes in attempts to affect the trading price of XRP. In short, XRP purchasers and the market lack information that issuers provide under the Securities Act and the Exchange Act when they solicit public investment and foster a secondary market when their securities are publicly traded.

VII. Larsen and Garlinghouse Knowingly or Recklessly Provided Substantial Assistance to Ripple's Unregistered Offering

A. Larsen Assumed the Risk that XRP Could Be a Security and Pushed the Offering Forward

369. Ripple and Larsen knew that XRP may be a security from the onset of the Offering and simply ignored legal requirements regarding registration and required periodic and current public disclosures. As described above in Section I.B, above, the Legal Memos Ripple commissioned in February and October 2012 warned that there was some risk that XRP would be considered an "investment contract" (and thus a security under the federal securities laws) depending on various factors.

370. Although both the February 2012 and the October 2012 Legal Memos warned that, if an XRP purchaser was induced to buy XRP as a speculative investment, this would increase the risk that XRP could be considered part of an investment contract, Larsen did not restrict his or Ripple's sales of XRP to "users" of XRP. To the contrary, under both Larsen's and Garlinghouse's stewardship, Ripple promoted XRP as a speculative investment when either no use case existed or, with the eventual development of the ODL product, only a small fraction of XRP arguably was being "used" for a few moments for non-investment purposes before being sold to investors.

371. Larsen understood that investors were purchasing XRP as an investment—precisely the situation that both the February 2012 and the October 2012 Legal Memos had warned could lead to a determination that XRP was a security.

372. For example, on February 6, 2017, "an early investor in XRP" wrote Larsen to "understand [his] view on XRP." Larsen responded that Ripple's "strategy of focusing on connecting banks serves . . . emerging trends" such that "the more banks that connect thru Ripple . . . the more demand we should see for XRP as an asset to reduce liquidity costs." Acknowledging the investors' "concerns around the current state of volume flows" for XRP, Larsen concluded:

"Frankly, the entire industry is really in the earliest stages of developments. Most volume in the space is speculation in advance of enterprise and eventually consumer flows."

373. Larsen also received additional warnings that XRP could be subject to the federal securities laws. On January 5, 2015, the head of an entity establishing a fund to invest in XRP forwarded to Larsen an email from the fund's attorney, who worked at a prominent global law firm. The attorney's email advised that, while the attorney did not know "whether a virtual currency is itself a security[,] . . . one certainly can create a security by packaging virtual currency."

374. Including as described above in this Complaint, Larsen provided substantial assistance to Ripple's unregistered Offering by making promotional statements, engaging in his own sales, speaking to investors in XRP to assuage their concerns about buying XRP, negotiating certain XRP sales, and approving decisions to sell XRP into the market when he was Ripple's CEO. Larsen acted at least recklessly while engaging in this conduct.

B. Garlinghouse Was Warned and Understood That XRP Had "Securities-Type" Characteristics

375. By at least June 2017, Garlinghouse knew or recklessly disregarded that Ripple's offers and sales of XRP were part of the offer and sale of an investment contract and thus a security.

376. For example, in an email conversation between Garlinghouse and Ripple Agent-1 on June 2015, Ripple Agent-1 expressed a desire to maintain a Ripple trading platform to specifically and uniquely target "non-consumer[s]." In response, Garlinghouse told Ripple Agent-1 it was "not clear to [him] . . . how one would reasonably discern (through an online process) between a speculator and a consumer." In essence, Garlinghouse conveyed that Ripple was then already unable to distinguish between sales it made to speculators and to "consumers."

377. On March 11, 2017, Ripple's then-chief compliance officer explained to Garlinghouse in an email that "XRP certainly has some 'securities-type' characteristics and we do need to hone our playbook/messaging."

378. On April 16, 2017, Garlinghouse was similarly advised by e-mail that the same chief compliance officer "want[ed] to make sure the verbiage [in employee offer letters regarding XRP notional value] doesn't put us at risk of XRP sounding like a security."

379. Garlinghouse, demonstrating a keen interest in the regulatory status of digital assets, also commented on Ripple's website immediately after the SEC issued the *DAO Report* in July 2017: "I say, if it looks like a duck and quacks like a duck then let's regulate it like a duck."

380. Garlinghouse nevertheless continued to make XRP sound like a security, including in interviews later in 2017 boasting about being "very long" XRP and in comments in connection with the XRP Escrow about how Ripple's efforts were meant to stabilize XRP's price.

381. The following year, in January 2018, Garlinghouse again demonstrated he understood at least certain factors that could determine whether XRP could be deemed a security. Only weeks after he touted being "very long" XRP in interviews, he commented, on an internal Ripple draft document, that XRP should not be promoted as an investment.

382. The following month, in a Yahoo! Finance interview he gave in February 2018, Garlinghouse acknowledged his understanding that "if there is not a real use case then it's really a securities offering. And if it's a securities offering there's not regulatory uncertainty. It should be regulated as a securities offering." At that time, Garlinghouse knew or recklessly disregarded that none of Ripple's sales of XRP up to that point had been with respect to any "use" of XRP.

383. Garlinghouse also admitted in a non-public setting that he is cognizant of the risk that XRP could be "classified as a security." Specifically, as reflected in an Equity Investor A employee email, dated July 23, 2018, Garlinghouse (accompanied by Larsen) met with Equity Investor A, "spoke for a while on the outstanding issue of whether XRP gets classified as a security," and noted that, while he was "optimistic that" it would not, he could "[]not guarantee that."

384. In a speech he gave in Manhattan in October 2019, Garlinghouse further acknowledged that people are "speculating on digital assets" and that "99.9% of all crypto trading today is just speculation," a factor he knew could lead to a determination that XRP was a security.

385. Throughout the course of this conduct, Garlinghouse had an incentive to make efforts to increase XRP's trading price and volume. Pursuant to an options grant of up to 500 million XRP dated December 13, 2016, Ripple would pay Garlinghouse in XRP, only if the volume weighted average price of XRP was "at least $0.02/XRP" for four consecutive weeks and the weekly XRP trading volume was at least 1.4 billion for at least four consecutive weeks.

386. Garlinghouse understands that Ripple is not profitable and cannot operate without continued sales of XRP, as he has publicly stated.

387. From April 2015 to the present, Garlinghouse provided substantial assistance to Ripple in conducting its Offering.

388. In addition to making the various promotional statements and efforts described above in this Complaint, Garlinghouse, as both COO and later CEO, participated in weekly XRP sales meetings where he exercised final decision-making authority over the timing and amount of Ripple's XRP sales, including whether to adjust Ripple's XRP sales based on factors such as market conditions, volume, price, or the capital needs of the company.

389. Garlinghouse similarly exercised final decision-making authority over how much XRP Ripple would offer and sell on a daily basis.

390. Garlinghouse also made the decision to establish the XRP Escrow and approved paying XRP as incentives to digital asset trading platforms for "listing" XRP or achieving certain trading volume benchmarks.

391. Garlinghouse acted at least recklessly while engaging in this conduct.

TOLLING AGREEMENTS

392. Ripple and the SEC entered into tolling agreements suspending the running of any applicable statute of limitations from April 1, 2019 through June 30, 2019, from July 7, 2019 through September 7, 2019, from September 8, 2019 through December 8, 2019, from December 9, 2019 through June 8, 2020, from June 9, 2020 through December 9, 2020, and from December 10, 2020 through December 24, 2020.

393. Larsen and the SEC entered into a tolling agreement suspending the running of any applicable statute of limitations from September 1, 2020, through December 31, 2020.

FIRST CLAIM FOR RELIEF
Violations of Sections 5(a) and 5(c) of the Securities Act
(All Defendants)

394. The Commission realleges and incorporates by reference here the allegations in paragraphs 1 through 393.

395. By virtue of the foregoing, (a) without a registration statement in effect as to that security, Defendants, directly and indirectly, made use of the means and instruments of transportation or communications in interstate commerce or of the mails to sell securities through the use or medium of any prospectus or otherwise, and (b) made use of the means and instruments of transportation or communication in interstate commerce or of the mails to offer to sell through the use or medium of a prospectus or otherwise, securities as to which no registration statement had been filed.

396. Ripple violated Sections 5(a) and 5(c) of the Securities Act by conducting the Offering. Ripple violated these provisions by, among other things, from 2013 through the present, directly and indirectly making use of the means and instruments of transportation or communications in interstate commerce or of the mails to sell 14.6 billion XRP without a registration statement in effect as to XRP, and by making use of the means and instruments of

transportation or communication in interstate commerce or of the mails to offer to sell XRP, which were offered and sold as securities, as to which no registration statement had been filed.

397. Larsen violated Sections 5(a) and 5(c) of the Securities Act by, from 2013 through the present, directly and indirectly making use of the means and instruments of transportation or communications in interstate commerce or of the mails to sell 1.7 billion XRP without a registration statement in effect as to XRP, and by making use of the means and instruments of transportation or communication in interstate commerce or of the mails to offer to sell XRP, which were offered and sold as securities, as to which no registration statement had been filed.

398. Garlinghouse violated Sections 5(a) and 5(c) of the Securities Act by, from 2016 through the present, directly and indirectly making use of the means and instruments of transportation or communications in interstate commerce or of the mails to sell 321 million XRP without a registration statement in effect as to XRP, and by making use of the means and instruments of transportation or communication in interstate commerce or of the mails to offer to sell XRP, which were offered and sold as securities, as to which no registration statement had been filed.

399. By reason of the conduct described above, Defendants, directly or indirectly, violated, are violating, and, unless enjoined, will continue to violate Securities Act Sections 5(a) and 5(c) [15 U.S.C. §§ 77e(a), (c)].

SECOND CLAIM FOR RELIEF
Aiding and Abetting Violations of Securities Act Sections 5(a) and 5(c)
(Larsen and Garlinghouse)

400. The Commission realleges and incorporates by reference here the allegations in paragraphs 1 through 393.

401. By engaging in the acts and conduct described in this Complaint, Defendants Larsen and Garlinghouse, directly or indirectly, knowingly or recklessly provided substantial assistance to

Ripple, who, from 2013 through the present, directly and indirectly have made and are making use of the means and instruments of transportation or communications in interstate commerce or of the mails to sell 14.6 billion XRP without a registration statement in effect as to XRP, and by making use of the means and instruments of transportation or communication in interstate commerce or of the mails to offer to sell XRP, which were offered and sold as securities, as to which no registration statement had been filed.

402. Larsen knowingly or recklessly provided substantial assistance to Ripple's violations of Sections 5(a) and 5(c) of the Securities Act including by: (i) from 2013 to 2016, deciding when and how much XRP Ripple would sell, establishing the XRP Escrow, making promotional statements with respect to XRP, and spearheading Ripple's efforts to attempt to increase demand for XRP; and (ii) from 2015 to the present, making his own sales of XRP.

403. Garlinghouse knowingly or recklessly provided substantial assistance to Ripple's violations of Sections 5(a) and 5(c) of the Securities Act, including by, from 2015 to the present, deciding when and how much XRP Ripple would sell, establishing the XRP Escrow, making promotional statements with respect to XRP, spearheading Ripple's efforts to attempt to increase demand for XRP, and making his own sales of XRP.

404. By reason of the foregoing, Larsen and Garlinghouse are liable pursuant to Section 15(b) of the Securities Act [15 U.S.C. § 77o(b)] for aiding and abetting Ripple's violations of Sections 5(a) and 5(c) of the Securities Act [15 U.S.C. § 77e(a), (c)] and, unless enjoined, will again aid and abet violations of these provisions.

PRAYER FOR RELIEF

WHEREFORE, the Commission respectfully requests that the Court enter a Final Judgment:

I.

Permanently enjoining Defendants, and each of their respective agents, servants, employees, attorneys and other persons in active concert or participation with any of them, from violating, directly or indirectly, Sections 5(a) and 5(c) of the Securities Act [15 U.S.C. § 77e(a), 77e(c)], including by delivering XRP to any persons or taking any other steps to effect any unregistered offer or sale of XRP;

II.

Ordering Defendants to disgorge all ill-gotten gains obtained within the statute of limitations, with prejudgment interest thereon, pursuant to Section 21(d)(5) of the Exchange Act [15 U.S.C. § 78u(d)(5)];

III.

Prohibiting Defendants from participating in any offering of digital asset securities pursuant to Section 21(d)(5) of the Exchange Act [15 U.S.C. § 78u(d)(5)];

IV.

Ordering Defendants to pay civil money penalties pursuant to Section 20(d) of the Securities Act [15 U.S.C. § 77t(d)]; and

V.

Granting any other and further relief this Court may deem just and proper for the benefit of investors.

JURY DEMAND

The Commission demands a trial by jury.

Dated: New York, New York
December 22, 2020

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

Syllabus **Case**

U.S. Supreme Court

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

Securities and Exchange Commission v. Howey Co.

No. 843

Argued May 2, 1946

Decided May 27, 1946

328 U.S. 293

CERTIORARI TO THE CIRCUIT COURT OF APPEALS

FOR THE FIFTH CIRCUIT

Syllabus

1. Upon the facts of this case, an offering of units of a citrus grove development, coupled with a contract for cultivating, marketing, and remitting the net proceeds to the investor, was an offering of an "investment contract" within the meaning of that term as used in the provision of § 2(1) of the Securities Act of 1933 defining "security" as including any "investment contract," and was therefore subject to the registration requirements of the Act. Pp. 328 U. S. 294-297, 328 U. S. 299.

2. For purposes of the Securities Act, an investment contract (undefined by the Act) means

a contract, transaction, or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise. Pp. 328 U. S. 298-299.

3. The fact that some purchasers, by declining to enter into the service contract, chose not to accept the offer of the investment contract in its entirety does not require a different result, since the Securities Act prohibits the offer, as well as the sale, of unregistered nonexempt securities. P. 328 U. S. 300.

4. The test of whether there is an "investment contract" under the Securities Act is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others; and, if that test be satisfied, it is immaterial whether the enterprise is speculative or nonspeculative, or whether there is a sale of property with or without intrinsic value. P. 328 U. S. 301.

5. The policy of the Securities Act of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae. P. 328 U. S. 301.

151 F.2d 714 reversed.

The Securities & Exchange Commission sued in the District Court to enjoin respondents from using the mails and instrumentalities of interstate commerce in the offer

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and sale of unregistered and nonexempt securities in violation of the Securities Act of 1933. The District Court denied the injunction. 60 F. Supp. 440. The Circuit Court of Appeals affirmed. 151 F.2d 714. This Court granted certiorari. 327 U.S. 773. *Reversed,* p. 328 U. S. 301.

MR. JUSTICE MURPHY delivered the opinion of the Court.

This case involves the application of § 2(1) of the Securities Act of 1933 [Footnote 1] to an offering of units of a citrus grove development, coupled with a contract for cultivating, marketing and remitting the net proceeds to the investor.

The Securities and Exchange Commission instituted this action to restrain the respondents from using the mails and instrumentalities of interstate commerce in the offer and sale of unregistered and nonexempt securities in violation of § 5(a) of the Act. The District Court denied the injunction, 60 F. Supp. 440, and the Fifth Circuit Court of Appeals affirmed the judgment, 151 F.2d 714. We granted certiorari, 327 U.S. 773, on a petition alleging that the ruling of the Circuit Court of Appeals conflicted with other federal and state decisions, and that it introduced a novel and unwarranted test under the statute which the Commission regarded as administratively impractical.

Most of the facts are stipulated. The respondents, W. J. Howey Company and Howey-in-the-Hills Service,

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Inc., are Florida corporations under direct common control and management. The Howey Company owns large tracts of citrus acreage in Lake County, Florida. During the past several years, it has planted about 500 acres annually, keeping half of the groves itself and offering the other half to the public "to help us finance additional development." Howey-in-the-Hills Service, Inc., is a service company engaged in cultivating and developing many of these groves, including the harvesting and marketing of the crops.

Each prospective customer is offered both a land sales contract and a service contract, after having been told that it is not feasible to invest in a grove unless service arrangements are made. While the purchaser is free to make arrangements with other service companies, the superiority of Howey-in-the-Hills Service, Inc., is stressed. Indeed, 85% of the acreage sold during the 3-year period ending May 31, 1943, was covered by service contracts with Howey-in-the-Hills Service, Inc.

The land sales contract with the Howey Company provides for a uniform purchase price per acre or fraction thereof, varying in amount only in accordance with the number of years the particular plot has been planted with citrus trees. Upon full payment of the purchase price, the land is conveyed to the purchaser by warranty deed. Purchases are usually made in narrow strips of land arranged so that an acre consists of a row of 48 trees. During the period between February 1, 1941, and May 31, 1943, 31 of the 42 persons making purchases bought less than 5 acres each. The average holding of these 31 persons was 1.33 acres, and sales of as little as O.65, O.7 and O.73 of an acre were made. These tracts are not separately fenced, and the sole indication of several ownership is found in small land marks intelligible only through a plat book record.

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The service contract, generally of a 10-year duration without option of cancellation, gives Howey-in-the-Hills Service, Inc., a leasehold interest and "full and complete" possession of the acreage. For a specified fee plus the cost of labor and materials, the company is given full discretion and authority over the cultivation of the groves and the harvest and marketing of the crops. The company is well established in the citrus business, and maintains a large force of skilled personnel and a great deal of equipment, including 75 tractors, sprayer wagons, fertilizer trucks, and the like. Without the consent of the company, the landowner or purchaser has no right of entry to market the crop; [Footnote 2] thus, there is ordinarily no right to specific fruit. The company is accountable only for an allocation of the net profits based upon a check made at the time of picking. All the produce is pooled by the respondent companies, which do business under their own names.

The purchasers, for the most part, are nonresidents of Florida. They are predominantly business and professional people who lack the knowledge, skill, and equipment necessary for the care and cultivation of citrus trees. They are attracted by the expectation of substantial profits. It was represented, for example, that profits during the 1943-1944 season amounted to 20%, and that even greater profits might be expected during the 1944-1945 season, although only a 10% annual return was to be expected over a 10-year period. Many of these purchasers are patrons of a resort hotel owned and operated by the Howey Company in a scenic section adjacent to the groves. The hotel's advertising mentions the fine groves in the vicinity, and the attention of the patrons is drawn to the

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groves as they are being escorted about the surrounding countryside. They are told that the groves are for sale; if they indicate an interest in the matter, they are then given a sales talk.

It is admitted that the mails and instrumentalities of interstate commerce are used in the sale of the land and service contracts, and that no registration statement or letter of notification has ever been filed with the Commission in accordance with the Securities Act of 1933 and the rules and regulations thereunder.

Section 2(1) of the Act defines the term "security" to include the commonly known documents traded for speculation or investment. [Footnote 3] This definition also includes "securities" of a more variable character, designated by such descriptive terms as "certificate of interest or participation in any profit-sharing agreement," "investment contract," and, "in general, any interest or instrument commonly known as a *security.'" The legal issue in this case turns upon a determination of whether, under the circumstances, the land sales contract, the warranty deed and the service contract together constitute an "investment contract" within the meaning of § 2(1). An affirmative answer brings into operation the registration requirements of § 5(a), unless the security* *is granted an exemption under § 3(b). The lower courts, in reaching a negative answer to this problem, treated the contracts and deeds*

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as separate transactions involving no more than an ordinary real estate sale and an agreement by the seller to manage the property for the buyer.

The term "investment contract" is undefined by the Securities Act or by relevant legislative reports. But the term was common in many state "blue sky" laws in existence prior to the adoption of the federal statute, and, although the term was also undefined by the state laws, it had been broadly construed by state courts so as to afford the investing public a full measure of protection. Form was disregarded for substance, and emphasis was placed upon economic reality. An investment contract thus came to mean a contract or scheme for "the placing of capital or laying out of money in a way intended to secure income or profit from its employment." *State v. Gopher Tire & Rubber Co.,* 146 Minn. 52, 56, 177 N.W. 937, 938. This definition was uniformly applied by state courts to a variety of situations where individuals were led to invest money in a common enterprise with the expectation that they would earn a profit solely through the efforts of the promoter or of some one other than themselves. [Footnote 4]

By including an investment contract within the scope of § 2(1) of the Securities Act, Congress was using a term the meaning of which had been crystalized by this prior judicial interpretation. It is therefore reasonable to attach that meaning to the term as used by Congress, especially since such a definition is consistent with the statutory aims. In other words, an investment contract, for purposes of the Securities Act, means a contract, transaction

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or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise. Such a definition necessarily underlies this Court's decision in *SEC v. Joiner Corp.,* 320 U. S. 344, and has been enunciated and applied many times by lower federal courts. [Footnote 5] It permits the fulfillment of the statutory purpose of compelling full and fair disclosure relative to the issuance of "the many types of instruments that, in our commercial world, fall within the ordinary concept of a security." H.Rep. No.85, 73rd Cong., 1st Sess., p. 11. It embodies a flexible, rather than a static, principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.

The transactions in this case clearly involve investment contracts, as so defined. The respondent companies are offering something more than fee simple interests in land, something different from a farm or orchard coupled with management services. They are offering an opportunity to contribute money and to share in the profits of a large citrus fruit enterprise managed and partly owned by respondents. They are offering this opportunity to persons who reside in distant localities and who lack the equipment

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and experience requisite to the cultivation, harvesting, and marketing of the citrus products. Such persons have no desire to occupy the land, or to develop it themselves; they are attracted solely by the prospects of a return on their investment. Indeed, individual development of the plots of land that are offered and sold would seldom be economically feasible, due to their small size. Such tracts gain utility as citrus groves only when cultivated and developed as component parts of a larger area. A common enterprise managed by respondents or third parties with adequate personnel and equipment is therefore essential if the investors are to achieve their paramount aim of a return on their investments. Their respective shares in this enterprise are evidenced by land sales contracts and warranty deeds, which serve as a convenient method of determining the investors' allocable shares of the profits. The resulting transfer of rights in land is purely incidental.

Thus, all the elements of a profit-seeking business venture are present here. The investors provide the capital and share in the earnings and profits; the promoters manage, control, and operate the enterprise. It follows that the arrangements whereby the investors' interests are made manifest involve investment contracts, regardless of the legal terminology in which such contracts are clothed. The investment contracts in this instance take the form of land sales contracts, warranty deeds, and service contracts which respondents offer to prospective investors. And respondents' failure to abide by the statutory and administrative rules in making such offerings, even though the failure result from a *bona fide* mistake as to the law, cannot be sanctioned under the Act.

This conclusion is unaffected by the fact that some purchasers choose not to accept the full offer of an investment contract by declining to enter into a service contract with

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the respondents. The Securities Act prohibits the offer, as well as the sale, of unregistered, nonexempt securities. [Footnote 6] Hence, it is enough that the respondents merely offer the essential ingredients of an investment contract.

We reject the suggestion of the Circuit Court of Appeals, 151 F.2d at 717, that an investment contract is necessarily missing where the enterprise is not speculative or promotional in character and where the tangible interest which is sold has intrinsic value independent of the success of the enterprise as a whole. The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others. If that test be satisfied, it is immaterial whether the enterprise is speculative or nonspeculative, or whether there is a sale of property with or without intrinsic value. *See SEC v. Joiner Corp., supra,* 320 U. S. 352. The statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae.

Reversed.

MR. JUSTICE JACKSON took no part in the consideration or decision of this case.

[Footnote 1]

48 Stat. 74, 15 U.S.C. § 77b(1).

[Footnote 2]

Some investors visited their particular plots annually, making suggestions as to care and cultivation, but without any legal rights in the matters.

[Footnote 3]

"The term 'security' means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral trust certificate, pre-organization certificate or subscription, transferable share, investment contract, voting trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a 'security,' or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."

[Footnote 4]

State v. Evans, 154 Minn. 95, 191 N.W. 425; *Klatt v. Guaranteed Bond Co.,* 213 Wis. 12, 250 N.W. 825; *State v. Health,* 199 N.C. 135, 153 S.E. 855; *Prohaska v. Hemmer-Miller*

Development Co., 256 Ill.App. 331; *People v. White,* 124 Cal. App. 548, 12 P.2d 1078; *Stevens v. Liberty Packing Corp.,* 111 N.J.Eq. 61, 161 A. 193. *See also Moore v. Stella,* 52 Cal. App. 2d 766, 127 P.2d 300.

[Footnote 5]

Atherton v. United States, 128 F.2d 463; *Penfield Co. v. SEC,* 143 F.2d 746; *SEC v. Universal Service Assn.,* 106 F.2d 232; *SEC v. Crude Oil Corp.,* 93 F.2d 844; *SEC v. Bailey,* 41 F. Supp. 647; *SEC v. Payne,* 35 F. Supp. 873; *SEC v. Bourbon Sales Corp.,* 47 F. Supp. 70; *SEC v. Wickham,* 12 F. Supp. 245; *SEC v. Timetrust, Inc.,* 28 F. Supp. 34; *SEC v. Pyne,* 33 F. Supp. 988. The Commission has followed the same definition in its own administrative proceedings. *In re Natural Resources Corporation,* 8 S.E.C. 635.

[Footnote 6]

The registration requirements of § 5 refer to sales of securities. Section 2(3) defines "sale" to include every "attempt or offer to dispose of, or solicitation of an offer to buy," a security for value.

MR. JUSTICE FRANKFURTER dissenting.

"Investment contract" is not a term of art; it is conception dependent upon the circumstances of a particular situation. If this case came before us on a finding authorized by Congress that the facts disclosed an "investment contract" within the general scope of § 2(1) of the Securities Act, 48 Stat. 74, 15 U.S.C. § 77b(1), the Securities and Exchange Commission's finding would govern unless, on the record, it was wholly unsupported. But

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that is not the case before us. Here, the ascertainment of the existence of an "investment contract" had to be made independently by the District Court, and it found against its existence. 60 F. Supp. 440. The Circuit Court of Appeals for the Fifth Circuit sustained that finding. 151 F.2d 714. If respect is to be paid to the wise rule of judicial administration under which this Court does not upset concurrent findings of two lower courts in the ascertainment of facts and the relevant inferences to be drawn from them, this case clearly calls for its application. *See Allen v. Trust Co. of Georgia,* 326 U. S. 630. For the crucial issue in this case turns on whether the contracts for the land and the contracts for the management of the property were, in reality, separate agreements, or merely parts of a single transaction. It is clear from its opinion that the District Court was warranted in its conclusion that the record does not establish the existence of an investment contract:

". . . the record in this case shows that not a single sale of citrus grove property was made by the Howey Company during the period involved in this suit, except to purchasers who actually inspected the property before purchasing the same. The record further discloses that no purchaser is required to engage the Service Company to care for his property, and that, of the fifty-one purchasers acquiring property during this period, only forty-two entered into contract with the Service Company for the care of the property."

60 F. Supp. at 442.

Simply because other arrangements may have the appearances of this transaction, but are employed as an evasion of the Securities Act, does not mean that the present contracts were evasive. I find nothing in the Securities Act to indicate that Congress meant to bring every innocent transaction within the scope of the Act simply because a perversion of them is covered by the Act.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION, Plaintiff, v. RIPPLE LABS INC., BRADLEY GARLINGHOUSE, and CHRISTIAN A. LARSEN Defendants.	Civil Action No. 1:20-CV-10832 ECF Case ORAL ARGUMENT REQUESTED

MEMORANDUM OF LAW IN SUPPORT OF DEFENDANT CHRISTIAN A. LARSEN'S MOTION TO DISMISS THE FIRST AMENDED COMPLAINT

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Defendant Christian A. Larsen respectfully submits this memorandum of law in support of his motion to dismiss the First Amended Complaint (ECF No. 46) (the "Amended Complaint") filed by the Securities & Exchange Commission (the "SEC") in its entirety as to him, pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure.

PRELIMINARY STATEMENT

In this case, the SEC seeks to regulate a novel and innovative financial asset by bringing an ill-conceived enforcement action in an undeveloped and highly uncertain area of the law. In its Amended Complaint, the SEC takes the extraordinary position that Ripple engaged in a multi-year unregistered offering of XRP—a digital asset that has been trading in a massive global market in plain view for eight years, where there are significant use cases for XRP apparent on the face of the Amended Complaint, and hundreds of billions of dollars of XRP transactions have been entered into across hundreds of digital asset exchanges. The SEC ultimately will be unable to demonstrate that transactions in XRP constitute securities because, among other reasons, transactions in XRP are not "investment contracts" under *SEC* v. *W.J. Howey Co.*, 328 U.S. 293 (1946). But this Court will not have to reach that question as to Mr. Larsen, the Executive Chairman of Ripple, because the SEC's allegations that Mr. Larsen violated Section 5 and 15(b) of the Securities Act of 1933 are deficient as a matter of law.

First, despite multiple attempts, the SEC has failed to adequately plead its Section 15(b) aiding and abetting claim, which requires that the SEC plausibly allege that Mr. Larsen knew or was reckless as to whether XRP was a security. At a minimum, to plead recklessness, the SEC must allege that it was "so obvious" to Mr. Larsen that he "must have been aware" both that XRP was an "investment contract" and that Ripple's conduct was improper. But there are multiple allegations in the Amended Complaint that render the SEC's claim that Mr. Larsen knew or was reckless as to whether XRP was a security implausible and defective as a matter of law. Even though the existence of XRP and Ripple's activities were publicly known throughout the entire eight years addressed in the Amended Complaint, the SEC never once publicly stated or even suggested that XRP transactions were securities. In the meantime, against the backdrop of the statutory exclusion of "currency" from the definition of "security" under the federal securities laws (*see* 15 U.S.C. § 78c(a)(10)), the Department of Justice ("DOJ") and Financial Crimes Enforcement Network ("FinCEN") took the position that XRP was a virtual currency and subsequently regulated XRP as a virtual currency—a fact the SEC acknowledges in the Amended Complaint. The SEC also declared that bitcoin and ether—the two digital assets most similar to XRP—are not securities, further undermining any claim that Mr. Larsen possessed the requisite knowledge or recklessness that XRP was in fact a security.

Far from plausibly supporting the SEC's theory, these allegations and facts subject to judicial notice fundamentally contradict the SEC's claim that Mr. Larsen acted knowingly or recklessly. What's left of the Amended Complaint as to Mr. Larsen are conclusory assertions and misstatements and misrepresentations of a handful of cherry-picked documents that in no way support an inference that he acted knowingly or recklessly. Reduced to their essence, the SEC alleges that Mr. Larsen, at most, was aware that there was "some risk" that XRP could be deemed to be a security—allegations that fall well short of pleading knowledge or recklessness under well-settled law. Ultimately, all the SEC has alleged is that Mr. Larsen took a position on a novel and unsettled legal issue different from the one the SEC ultimately adopted in December 2020 when it filed this case. Such allegations are insufficient to state a claim that Mr. Larsen acted knowingly or recklessly.

The SEC's aiding and abetting claim against Mr. Larsen also fails because it does not adequately plead that he "substantially assisted" Ripple's alleged Section 5 violations—another essential element of an aiding and abetting claim under Section 15(b). Critically, the SEC does not allege that Mr. Larsen made even a single statement promoting XRP as an investment opportunity. Threadbare allegations that Mr. Larsen attended a handful of meetings and was copied on certain communications are insufficient to plead substantial assistance with respect to specific sales by Ripple.

Second, the SEC alleges that Mr. Larsen personally engaged in over $450 million in XRP sales in violation of Section 5. But again, as a matter of law, the SEC's claim should be dismissed because it fails to adequately allege facts showing that even one offer or sale of XRP was domestic as required by the Supreme Court's decision in *Morrison* v. *National Australia Bank Ltd.*, 561 U.S. 247, 268–70, 273 (2010). In four paragraphs of its 440-paragraph Amended Complaint, the SEC asserts in a conclusory fashion that Mr. Larsen's "directed his offers and sales of XRP from within the United States" and "made offers and sales of XRP to persons in the United States." It is well established that such allegations are insufficient in the Second Circuit to plead a domestic offer or sale. The SEC has resorted to such vague allegations because, after a two-and-a-half-year investigation, it is fully aware that its claim is doomed to fail since virtually all of the XRP transactions at issue in the Amended Complaint were completed on foreign exchanges. And even if the SEC has adequately alleged some domestic elements of the transactions, they are nevertheless outside the reach of Section 5 because the offers or sales are "predominantly foreign" even on the face of the Amended Complaint.

Third, the SEC's claims for disgorgement and monetary relief are time-barred as a result of the SEC's own pleading choices. The SEC chose to plead one ongoing multi-year offering (likely to avoid the dictates of *Morrison*). In these circumstances, the statute of limitations on

Mr. Larsen's XRP sales began to run in 2013—rather than 2015 as the SEC wrongfully insists—and expired in 2018.

For all these reasons, the claims against Mr. Larsen should be dismissed with prejudice.

STATEMENT OF FACTS

I. The Creation of XRP and the Founding of Ripple

In 2011, Co-Founder[1] began to spearhead the creation of a state-of-the-art blockchain that ultimately became known as the XRP Ledger. (Compl. ¶ 38.) The XRP Ledger is software code that operates as a peer-to-peer database spread across a network of computers that records transaction data. (*Id*. ¶ 39.) It was designed to be a superior alternative to bitcoin because it was more secure and did not involve inefficient mining of any tokens needed to transact. Co-Founder recruited Cryptographer-1 and Ripple Agent-1 to work with him to write the XRP Ledger's initial code. (*Id*. ¶ 38.) In 2012, when the XRP Ledger was deployed to the servers that would run it, a fixed supply of 100 billion of the token native to the XRP Ledger—what became known as "XRP"—was automatically created. (*Id*. ¶ 45.)

In February 2012—before Mr. Larsen had joined the XRP project team, before the XRP Ledger had been completed, and before Ripple was incorporated—Co-Founder and others requested legal advice from a reputable law firm on [redacted] (Flumenbaum Decl. Ex. A.)[2] It included [redacted]

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[1] The terms "Co-Founder" and "Ripple Agent-1" are used in the Amended Complaint and defined at paragraphs 20 and 22 of the Amended Complaint.

[2] Because the SEC "relies heavily upon [the] terms and effect" of the February and October 2012 legal memoranda in its Amended Complaint and they are incorporated by reference, the entire documents may be considered on a motion to dismiss. *See Chambers* v. *Time Warner, Inc.*, 282 F.3d 147, 153 (2d Cir. 2002).

[redacted] and in light of this early advice, the proposed business plan was modified.

In mid-2012, Mr. Larsen decided to join the project. (Compl. ¶ 42.) In September 2012, NewCoin, Inc., later known as Ripple Labs Inc., was incorporated. (*Id*. ¶¶ 16, 44.) Ripple was formed to create products, certain of which would operate using the XRP Ledger. (*Id*. ¶ 42.) Ripple was granted 80 billion of the XRP that had been created. (*Id*. ¶ 46.) Co-Founder and Mr. Larsen each ultimately received nine billion XRP, while Ripple Agent-1 received two billion XRP. (*Id*. ¶¶ 18, 20, 22, 46.) Mr. Larsen was named the CEO of the company. (*Id*. ¶¶ 18, 42–43.)

II. Mr. Larsen Receives Legal Advice that XRP is Very Likely Not a Security

In October 2012, the law firm updated its initial advice. (Flumenbaum Decl. Ex. B.) In its second memorandum, [redacted] Importantly, the memorandum never concluded that Ripple Credits were "investment contracts" or "securities."

The Amended Complaint presents a misleading and distorted picture of the memorandum. As one example, the memorandum did not, as the SEC alleges (Compl. ¶ 53), suggest that the mere fact that parties engaged in "speculative investment trading" with respect to XRP would determine whether XRP was a security; rather, it stated that [redacted] There was, for example, no recommendation that the Founders or the Company should inquire as to the purpose of those receiving XRP so as to ensure those recipients were not receiving the XRP for speculative purposes.

And while the SEC alleges that the October 2012 memorandum "advise[d] Ripple and Larsen to contact the SEC to obtain clarity as to whether XRP was a security under the federal securities laws," (Compl. ¶ 55), that is likewise false. Rather, the memorandum stated [redacted]

III. Mr. Larsen's Role as Chief Executive of Ripple from 2012 to 2016

As CEO of Ripple, Mr. Larsen was focused on doing what the SEC concedes Ripple was formed to do—create products, some of which would operate in conjunction with the XRP Ledger and XRP. (Compl. ¶ 42.)

Between 2012 and 2016, Ripple was focused on using its proprietary products, some of which worked with the XRP Ledger, to create a payments network—or the world's first "distributed currency exchange." As shown by the documents referenced in the SEC's own Amended Complaint, Ripple wished to promote adoption of XRP as a currency with no counterparty risk that could be used in Ripple's payment network. Ripple described XRP as "the equivalent to paper cash in the physical world," a "Unit of Account," "Medium of Exchange," and "Store of Wealth." Mr. Larsen also stated publicly on numerous occasions that he considered XRP to be a currency. For example, in a February 19, 2014 interview, Mr. Larsen stated that XRP "is a math-based currency like [b]itcoin" because it is "a currency without a counterparty." Similarly, in an April 14, 2014 interview, Mr. Larsen stated "[t]here is a currency built into [the XRP Ledger], called XRP."[3]

During Mr. Larsen's tenure as CEO, multiple government agencies agreed with Mr. Larsen's view that XRP was a currency, not a security—all while the SEC remained silent. As the Amended Complaint acknowledges, in May 2015, Ripple reached a settlement with both FinCEN and the DOJ relating to prior XRP sales by Ripple's wholly-owned subsidiary, XRP II, LLC ("XRP II"), and specifically to XRP II's registration as money services businesses and implementation of an anti-money-laundering program. (Flumenbaum Decl. Exs. C & D.)[4] In a jointly issued Statement of Facts, both agencies publicly concluded that XRP was a "virtual currency," that Ripple "provided virtual currency exchange transaction services," and that its subsidiary, XRP II, "engaged in sales of virtual currency to third parties." (*Id.*, Attach. A at 1, 5.) "Virtual currency" is described by FinCEN as "a medium of exchange that can operate like

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[3] Because the SEC references the documents described in this paragraph at paragraphs 63, 246, and 265 of the Amended Complaint, the Court may properly consider their terms on this motion to dismiss. *See supra* n.2.

[4] Because the SEC describes the terms of the DOJ and FinCEN settlement in the Amended Complaint (*see* ¶¶ 379–80) and they are subject to judicial notice, Mr. Larsen may rely on Exs. C and D in his motion to dismiss. *See supra* n.2. *See also Sullivan* v. *Barclays PLC*, No. 13-cv-2811 (PKC), 2017 WL 685570, at *21 (S.D.N.Y. Feb. 21, 2017) (taking judicial notice of DOJ settlement).

currency but does not have all the attributes of 'real' currency . . . including legal tender status."[5] The Statement of Facts repeated that XRP was a "currency," or "money" more than a dozen times. The settlement also established that XRP II was and continues to be a money services business under the Bank Secrecy Act. (*See id.* ¶ 379 ("In May 2015, Ripple and XRP II agreed . . . to settle charges brought by the [DOJ] and FinCEN for failing to register as a "Money Services Business" under the Bank Secrecy Act and . . . to comply with other regulatory requirements with respect to Ripple's XRP sales, which the settlement called 'virtual currency'"); *id.* ¶ 19 (XRP II "is the entity through which Ripple offered and sold most of its XRP in the Offering. XRP II is registered as a money service business with [FinCEN]").)[6] The DOJ has continued to confirm its belief that XRP is a currency to this day. In August and October of last year, the DOJ reiterated its view that XRP is a currency, calling it "one of the major virtual currencies" in use alongside ether and bitcoin.[7]

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5 Dep't of the Treasury, *Application of FinCEN's Regulations to Certain Business Models Involving Convertible Virtual Currencies*, FIN-2019-G001 at 7 (May 9, 2019), available https://www.fincen.gov/sites/default/files/2019-05/FinCEN%20Guidance%20CVC%20FINAL%20508.pdf. Courts routinely take judicial notice of governmental records or reports published on government websites. *See Wells Fargo Bank, N.A.* v. *Wright Mill Holdings, LLC*, 127 F. Supp. 3d 156, 166 (S.D.N.Y. 2015) ("Courts routinely take judicial notice of such governmental records [retrieved from official government websites].")

6 "Money Services Businesses" are exclusively regulated by FinCEN for anti-money laundering (as reflected in the DOJ/FinCEN settlement), whereas anti-money laundering oversight for broker-dealers in securities is under the joint jurisdiction of FinCEN, FINRA and the SEC. *See* Declaration of Matthew C. Solomon in Support of Garlinghouse Motion to Dismiss ("Solomon Decl."), Ex. B (FinCEN, *Fact Sheet on MSB Registration Rule*, available at https://www.fincen.gov/fact-sheet-msb-registration-rule.) The Court may take judicial notice of this document. *See supra* n.5.

7 U.S. Dep't of Justice, *Cryptocurrency Enforcement Framework*, *Report of the Attorney General's Cyber Digital Task Force*, at 25 (Oct. 8, 2020), available at https://www.justice.gov/ag/page/file/1326061/download. This Court may take judicial notice of this report. *See supra* n.5.

Other regulatory bodies' actions also caused Mr. Larsen to be confident that XRP was a currency not a security. In 2016, XRP II obtained from the New York State Department of Financial Services ("NYDFS") a "BitLicense" or "virtual currency license" to enable it to sell XRP for, among others, financial institutions. (*See* Compl. ¶ 19 ("XRP II is registered . . . as a virtual currency business with the [NYDFS]").) From 2012 to mid-2017, while other agencies were investigating and bringing enforcement actions regarding virtual currencies generally and XRP in particular, the SEC did not release any guidance on, nor did it show any concern with, XRP or Ripple's activities, or even digital assets more broadly.

IV. Mr. Larsen Transitions from CEO to Executive Chairman of Ripple's Board of Directors in late 2016

On November 1, 2016—more than four years before this action was brought—Ripple announced that Mr. Larsen had decided to transition from his operational role as CEO of Ripple to executive chairman of Ripple's board of directors. (Compl. ¶ 18.) Brad Garlinghouse was named as the new CEO effective on January 1, 2017. (*Id.* ¶ 17.) Larsen's transition to Executive Chairman occurred approximately eight months before the SEC released its investigative report into The DAO matter. In that report, the SEC stated ***for the first time*** that the U.S. securities laws may apply to some offering, selling, and trading of interests in digital assets.[8] (Compl. ¶ 37.) The report examined a completely factually distinct case from Ripple: it concerned digital assets promoted as virtual shares in a virtual issuer, The DAO, which was expressly described as an alternative to typical corporate investments.

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[8] *See* Sec. & Exch. Comm'n, *SEC Issues Investigative Report Concluding DAO Tokens, a Digital Asset, Were Securities: U.S. Securities Laws May Apply to Offers, Sales, and Trading of Interests in Virtual Organizations*, No. 2017-131 (July 25, 2017) ("*The DAO Report*"). The Court may consider this document because the SEC relies on it in the Amended Complaint. *See supra* n.2.

After the DAO Report, the SEC itself stated publicly in 2018 that the two digital assets most similar to XRP—bitcoin and ether—were not securities.[9] In addition, as late as early 2020, one of the SEC Commissioners, Hester Peirce, indicated that in her view a cryptocurrency may start out as a security, but over time as its uses become more developed and accepted, it becomes a currency and not a security.[10] In early 2020, the then-Chairman of the CFTC, Heath Tarbert, also said, in response to a question about whether XRP was a security, "[i]t's unclear . . . . We're working closely with the SEC to figure out what falls into what box."[11]

V. Mr. Larsen's Sales of XRP

From 2013 to 2020, Mr. Larsen sold his personal XRP predominantly through a foreign market maker.[12] As the Amended Complaint acknowledges, this foreign market maker sold Mr. Larsen's XRP on "digital asset trading platforms with worldwide operations and customers," "through certain digital asset trading platforms whose parent corporations are located outside the United States," and "to investors all over the world." (Compl. ¶¶ 174, 177.)

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9 Solomon Decl. Ex. J, William Hinman, Dir., Div. of Corp. Fin., Sec. & Exch. Comm'n, *Digital Assets Transactions: When* Howey *Met* Gary *(Plastic*), (June 14, 2018), available at https://www.sec.gov/news/speech/speech-hinman-061418. This Court may take judicial notice of the fact that Mr. Hinman said in this speech that bitcoin and ether were not securities. *See In re Bear Stearns Cos., Inc. Sec., Deriv., and ERISA Litig.*, 763 F. Supp. 2d 423, 582 (S.D.N.Y. 2011) (taking judicial notice of the fact that certain Congressional speeches contained certain information.)

10 Hester Peirce, Comm'nr, Sec. & Exch. Comm'n, *Running on Empty: A Proposal to Fill the Gap Between Regulation and Decentralization* (Feb. 6, 2020), https://www.sec.gov/news/speech/peirce-remarks-blockress-2020-02-06. This Court may take judicial notice of the fact and contents of this speech. *See supra* n.9.

11 Cheddar, *Interview with CFTC Chairman Heath Tarbert* (Jan. 13, 2020), https://twitter.com/cheddar/status/1216739497121107970. The Court may take judicial notice of the fact and contents of this speech. *See supra* n.9.

12 The term "Market Maker" is defined in the Amended Complaint as "a global digital asset trading firm with an office in the United States." (Compl. ¶ 96.)

LEGAL STANDARD

To survive a Federal Rule of Civil Procedure 12(b)(6) motion to dismiss, the SEC's Amended Complaint must plead sufficient factual allegations that, "accepted as true, [] 'state a claim to relief that is plausible on its face.'" *Ashcroft* v. *Iqbal*, 556 U.S. 662, 678 (2009) (quoting *Bell Atl. Corp.* v. *Twombly*, 550 U.S. 544, 570 (2007)). "[T]hreadbare recitals of the elements of a cause of action, supported by mere conclusory statements," *Harris* v. *Mills*, 572 F.3d 66, 72 (2d Cir. 2009) (citation omitted), and allegations "contradicted" by documents referenced in the complaint "are insufficient to defeat a motion to dismiss," *Matusovsky* v. *Merrill Lynch*, 186 F. Supp. 2d 397, 400 (S.D.N.Y. 2002) (citation omitted). Dismissal pursuant to Rule 12(b)(6) is also appropriate where a statute of limitations defense "appears on the face of the complaint." *Ellul* v. *Congregation of Christian Brothers*, 774 F.3d 791, 798 n.12 (2d Cir. 2014).

In assessing Mr. Larsen's motion to dismiss, this Court is not required to consider the SEC's Amended Complaint in a vacuum: It is permitted to consider all the allegations in the SEC's Amended Complaint, matters of which a court can take judicial notice, and any documents that the SEC relies upon in the Amended Complaint. *See State Univs. Ret. Sys. of Illinois* v. *Astrazeneca PLC*, 334 F. App'x 404, 405 (2d Cir. 2009) (on motion to dismiss, courts "consider the complaint in its entirety, as well . . . documents incorporated into the complaint by reference, and matters of which a court may take judicial notice.").

ARGUMENT

I. The Second Claim for Relief Should Be Dismissed Because the Amended Complaint Fails to State a Section 15(b) Claim Against Mr. Larsen.

In order to state a claim against Mr. Larsen for aiding and abetting a violation of Section 5 pursuant to Section 15(b) of the Securities Act of 1933, the SEC must allege that Mr. Larsen "knowingly or recklessly provide[d] substantial assistance to another person in violation of [Section 5]." 15 U.S.C. § 77o(b). The facts set forth in the Amended Complaint do not support a plausible inference that Mr. Larsen (1) acted knowingly or recklessly with respect to the propriety of Ripple's XRP sales, or (2) substantially assisted any alleged unregistered sale or offer by Ripple. In particular, the SEC's failure to plead specific Ripple transactions that Mr. Larsen knew were improper or that he substantially assisted is fatal to the Section 15(b) claim. Therefore, on either of these grounds, the Section 15(b) claim against Mr. Larsen must be dismissed.

A. The Amended Complaint Fails to Plausibly Allege Knowledge or Recklessness

To adequately plead that Mr. Larsen aided and abetted Ripple in its alleged violation of Section 5, the SEC must allege that Mr. Larsen had a culpable state of mind—that he both knew or was reckless as to the facts allegedly making XRP transactions investment contracts *and* knew or was reckless to the fact that Ripple's activities were "improper." *SEC* v. *Paulsen*, No. 18 CIV. 6718 (PGG), 2020 WL 6263180, at *14–15 (S.D.N.Y. Oct. 23, 2020) (finding defendant liable for aiding and abetting where he "knew that [the primary violator's] conduct was improper and illegal; and was concerned that his own involvement in that conduct presented a risk to him"); *SEC* v. *Mattessich*, 407 F. Supp. 3d 264, 272 (S.D.N.Y. Sept. 9, 2019) (assessing whether defendants "knew their conduct to be wrongful"); *SEC* v. *Espuelas*, 905 F. Supp. 2d 507, 518 & n.5 (S.D.N.Y. 2012) (explaining that the SEC must show that the defendant knew or recklessly disregarded that the underlying activity that constitutes the primary violation was "improper"); *SEC* v. *River N. Equity LLC*, 415 F. Supp. 3d 853, 859 (N.D. Ill. 2019) (requiring that the SEC plead "the alleged aider and abettor's general awareness that his actions were part of an overall illegal course of conduct").

To plead recklessness, the SEC must plausibly allege facts showing that Mr. Larsen acted "in the face of an unjustifiably high risk of harm that is either known or so obvious that it should be known." *Farmer* v. *Brennan*, 511 U.S. 825, 836 (1994). Recklessness is "highly unreasonable" conduct that represents "an extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it." *Novak* v. *Kasaks*, 216 F.3d 300, 308 (2d Cir. 2000) (quoting *Rolf* v. *Blyth, Eastman Dillon & Co., Inc.*, 570 F.2d 38, 47 (2d Cir. 1978)). Even allegations of gross negligence do not suffice. *See* Brief for the Securities and Exchange Commission as Amicus Curiae Supporting Respondents at 26, *Cent. Bank of Denver* v. *First Interstate Bank of Denver*, 511 U.S. 164 (1994) ("[Recklessness] requires a state of mind closer to conscious intent than to gross negligence").

Thus, at a minimum, the SEC must plausibly allege facts showing that—despite significant regulatory uncertainty—it was "so obvious" that Ripple's offers or sales of XRP were improper that Mr. Larsen "must have been aware of it." *In re BISYS Sec. Litig.*, 397 F. Supp. 2d 430, 441 (S.D.N.Y. 2005) (quoting *Novak*, 216 F.3d at 308). This standard has an objective component that creates a supremely high burden, one that the SEC cannot and does not meet in its Amended Complaint.

(1) The Amended Complaint Demonstrates That Mr. Larsen Did Not Have Knowledge or Act with Recklessness

The SEC's own allegations, the documents it relies on in its Amended Complaint, and documents susceptible to judicial notice—all of which this Court may rely on in evaluating a motion to dismiss—show that Mr. Larsen, as a matter of law, did not possess knowledge or recklessness sufficient to support a Section 15(b) aiding and abetting claim. At most, the facts show there was a high degree of regulatory uncertainty in a novel and nascent industry regarding whether XRP was a currency or a security. As the Supreme Court itself has acknowledged, when "statutory text and relevant court and agency guidance allow for more than one reasonable interpretation . . . a defendant who merely adopts one such interpretation" does not act with knowledge or recklessness because "Congress could not have intended such a result for those who followed an interpretation that could reasonably have found support in the courts." *Safeco Ins. Co. of Am.* v. *Burr*, 551 U.S. 47, 70 n.20 (2007); *see also City of Pontiac Policemen's & Firemen's Ret. Sys.* v. *UBS AG*, 752 F.3d 173, 187–88 (2d Cir. 2014) (holding that appreciation of "uncertainty and disagreement . . . in the market at large" does not constitute recklessness). The SEC's allegation of recklessness rests on the naïve and inaccurate assumption that—throughout the entire eight years of Mr. Larsen's alleged violative conduct—whether XRP was a security was a black-and-white issue, such that anyone, including Mr. Larsen, must have known that it was in fact a security. In reality, as the SEC's own Amended Complaint makes clear and as statements from other regulators indicate, XRP's classification was a subject on which reasonable minds could and did differ at the time of Mr. Larsen's alleged conduct. As a matter of law, one cannot be reckless if there is legal uncertainty.

As the Amended Complaint acknowledges, in 2015, while Mr. Larsen was CEO of Ripple, multiple federal agencies—namely the DOJ and FinCEN—took the position that XRP was a currency, leading Ripple to agree to penalties pursuant to federal anti-money laundering and other regulations. As part of a 2015 settlement with Ripple, both agencies publicly concluded that XRP was a "virtual currency." (Flumenbaum Decl. Exs. C & D, Attach. A at 1, 4.) Moreover, the SEC itself described Ripple as a "digital currency company" during this time period. *Matter of Mellon*, Exchange Act Release No. 78924, 2016 WL 5340192 (Sept. 23, 2016). "Currency" is expressly excluded from the definition of a "security" under federal law.

15 U.S.C. § 78c(a)(10) (stating that the definition of security under the Securities Exchange Act "shall not include currency"). Similarly, FinCEN and the DOJ concluded during this time period that Ripple "provided virtual currency exchange transaction services" and XRP II "engaged in sales of virtual currency to third parties." (Flumenbaum Decl. Exs. C & D, Attach. A, at 1, 5.) Both the DOJ and FinCEN subsequently regulated XRP II as a "money services business." (Compl. ¶ 19; *see also id.* ¶ 379 (explaining that the DOJ and FinCEN settled charges relating to Ripple and XRP II's failure to register as a money services business).) FinCEN's regulations define money services businesses to *exclude* "person[s] registered with, and functionally regulated or examined by, the SEC or the CFTC[.]" 31 C.F.R. § 1010.100(ff)(8)(ii) (2014). The DOJ/FinCEN settlement also expressly permitted future sales and distributions of XRP, including in secondary markets, provided that Ripple complied with federal laws and regulations applicable to money services businesses (some of which are not applicable to sellers of securities), which it did. (Flumenbaum Decl. Exs. C & D, Attach. B, at 1.) Thus, it was objectively reasonable for a person in Mr. Larsen's circumstances to conclude that XRP was a currency within the jurisdiction of FinCEN and not a security within the jurisdiction of the SEC.

Furthermore, even though the existence of XRP and Ripple's activities was publicly known throughout the entire eight years addressed in the Amended Complaint, the SEC never once publicly stated or even suggested that XRP transactions were securities. In fact, the SEC waited until July 2017—after Mr. Larsen was no longer Chief Executive Officer of Ripple—to issue any guidance on when any digital assets might be considered a security. (*See* Compl. ¶ 37.) And in that guidance, the SEC stressed that whether the offering, selling, and trading of interests in digital assets involves securities "depend[s] on the particular facts and circumstances" and described a case completely factually distinct from Ripple.[13]

Finally, in 2018 and 2019, the SEC itself declared that bitcoin and ether—the two digital assets most similar to XRP—were not securities.[14] It is difficult to conceptualize how a person in Mr. Larsen's position would consider it "so obvious" that XRP was a security that Mr. Larsen "must have been aware" of it in circumstances where the SEC said that two other substantially similar digital assets were not securities. In addition, even in early 2020, SEC Commissioner Hester Peirce and the then-Chairman of the CFTC both made pronouncements illustrating the regulatory uncertainty around the status of digital assets such as XRP.[15] These pronouncements make it impossible for the SEC to allege plausibly that Mr. Larsen possessed the necessary knowledge or acted recklessly as to whether XRP was in fact a security.

(2) The Amended Complaint's Allegations in Support of Knowledge or Recklessness Are Deficient

In the face of these undisputed allegations set forth in the Amended Complaint and facts subject to judicial notice, which affirmatively establish the absence of knowledge or recklessness, the SEC pleads no facts showing that Mr. Larsen knew, or that it was so obvious he must have been aware, that Ripple's conduct was in any way improper—an element it must plead. *See, e.g., Paulsen*, 2020 WL 6263180 at *14–15. There are no allegations, for example, that Mr. Larsen attempted to conceal anything about his involvement in Ripple's conduct, or that he communicated to anyone else that he considered Ripple's conduct to be improper. Nor is it alleged that he had access to facts that made it "so obvious" that XRP transactions constituted

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[13] *See The DAO Report*, supra n.8, at 10.

[14] *See* Hinman, Solomon Decl. Ex. J, *supra* n.9.

[15] *See* Peirce and Tarbert, *supra* nn.10 & 11.

"investment contracts." Indeed, it took the SEC eight years to bring a lawsuit alleging that Ripple's conduct violated the securities laws. The SEC's failure to plead any facts suggesting that Mr. Larsen knew or was reckless as to whether Ripple's conduct was improper alone is fatal to the SEC's claim.

Moreover, the SEC nowhere alleges in its Amended Complaint that Mr. Larsen actually knew, or that it was so obvious that he must have been aware, that XRP possessed the attributes of an "investment contract." The SEC cannot plausibly allege as much, because its assertion in this case that XRP is an "investment contract" constitutes a novel and unprecedented legal theory that was never articulated in any law, regulation, or official SEC pronouncement before the filing of this action. Instead, the SEC alleges that Mr. Larsen was aware of certain historical facts that the SEC is now using to build its case that XRP is a security. For example, the Amended Complaint alleges that Mr. Larsen knew or recklessly disregarded that XRP purchasers "were using money to purchase XRP and that Ripple was pooling that capital to fund its efforts to create profits for Ripple and XRP purchasers" (Compl. ¶ 90; *see also id.* ¶ 293), and that "XRP purchasers had a reasonable expectation of deriving profits by buying and selling XRP on these digital asset trading platforms" (*id.* ¶ 169; *see also id.* ¶ 242). As an initial matter, these allegations are wholly conclusory. But even more importantly, they cannot lead to the conclusion that Mr. Larsen knew or was reckless as to XRP being a security. For example, the same allegations could be true of commodities like gold and foreign currency, which are routinely bought and sold by investors in the expectation of profits. *See Noa* v. *Key Futures, Inc.*, 638 F.2d 77, 79 (9th Cir. 1980) (finding that purchases of silver bars were not securities because profits did not depend on managerial efforts of defendant).

Reduced to their essence, the SEC's allegations of knowledge or recklessness boil down to a generalized claim that Mr. Larsen was aware there was "some risk that XRP could be considered an 'investment contract' . . . depending on various factors" (Compl. ¶¶ 53, 395); that he "assume[d] a risk he knew existed—that the sale of [XRP] could constitute an offering of securities" (*id*. ¶ 58; *see also id*. ¶ 4); and that he "knew that XRP *may be* a security" (*id.* ¶ 395) (emphasis added). The SEC alleges no facts to support the culpable knowledge or recklessness required to plead an aiding and abetting claim.[16] *See Farmer*, 511 U.S at 836 (defining recklessness as acting "in the face of an *unjustifiably high risk of harm* that is either known or so obvious that it should be known." (emphasis added)).

The SEC's allegations are founded on a blatant mischaracterization of the two legal memoranda Ripple and Mr. Larsen received in 2012[17] and other documents referenced in the Amended Complaint. The SEC's scienter theory rests on its argument that Mr. Larsen "received legal advice as early as 2012 that under certain circumstances XRP could be considered an 'investment contract' and therefore a security under the federal securities laws" and that Mr. Larsen "ignored this advice." (Compl. ¶¶ 3, 4.) But, as the Court will see when it reviews the memoranda, the October 2012 memorandum discussed [redacted]

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[16] The SEC relies on one out-of-context email from Mr. Larsen from seven years ago—before the DOJ/FinCEN settlement—suggesting that he was aware of the risk that he could possibly be deemed an issuer of securities. (*See* Compl. ¶¶ 57–58.) The acknowledgement of "some risk" is insufficient as a matter of law to support a finding of recklessness. *See Farmer*, 511 U.S. at 836.

[17] It is well-established that, in merely defending against the SEC's allegations regarding the non-privileged legal memoranda, Mr. Larsen does not effect any broader waiver of the privilege. *See Ward* v. *Succession of Freeman*, 854 F.2d 780, 789 (5th Cir. 1988) (holding that when opposing party puts previously privileged materials at issue in the case, a defensive use of the materials does not effect a waiver). Mr. Larsen maintains that the mere disclosure of the legal memoranda has not effected a broader subject matter waiver.

[redacted] [redacted] As to the allegation that Mr. Larsen "ignored" the advice, the memoranda advised [redacted] And that is exactly what Mr. Larsen and Ripple did. The SEC fails to allege even *one instance* in the relevant eight-year period where Mr. Larsen promoted XRP as an investment opportunity or as a speculative trading vehicle. The SEC also ignores the impact of its own inaction, the DOJ/FinCEN settlement, and its own statements relating to bitcoin and ether in connection with this 2012 legal memorandum. And again, while the SEC seems fixated on the idea that Mr. Larsen appreciated that investors were purchasing XRP for speculation, that is not sufficient to render XRP a security. Otherwise, every commodity and currency would be a security.

B. The SEC Fails to Plausibly Allege Substantial Assistance by Mr. Larsen

In addition to failing to plausibly allege knowledge or recklessness under Section 15(b), the SEC's allegations regarding Mr. Larsen's conduct are plainly inadequate to plead "substantial assistance," as they fail to describe how Mr. Larsen "[sought] by his action to make [Ripple's sales] succeed." *SEC* v. *Apuzzo*, 689 F.3d 204, 206 (2d Cir. 2012). Instead, the Amended Complaint relies on Mr. Larsen's various titles at Ripple to reframe ordinary management and oversight activity as somehow essential to Ripple's XRP sales. These allegations fail to establish substantial assistance with respect to specific sales, providing another reason for dismissal of the Section 15(b) claim.

The SEC alleges that Mr. Larsen, during his tenure as CEO from 2012 to 2016, "had final decision-making authority over" decisions related to XRP sales, and approved or was consulted on various aspects of the sales. (Compl. ¶ 98; *id.* ¶¶ 73, 92, 100, 101, 110, 116, 152.) Pleaded at this level of generality, such allegations merely restate that Mr. Larsen acted as Ripple's CEO, which is plainly inadequate to establish substantial assistance. *See SEC* v. *Rio Tinto plc*, No. 17 CIV. 7994 (AT), 2019 WL 1244933, at *18 (S.D.N.Y. Mar. 18, 2019) (Torres, J.) (requiring that defendant "participate[] in [the violation] as in something that he wished to bring about, and that he sought by his action to make it succeed"); *see also SEC* v. *CMKM Diamonds, Inc.*, 729 F.3d 1248, 1258 (9th Cir. 2013) ("A participant's title, standing alone, cannot determine liability under Section 5, because the mere fact that a defendant is labeled as an issuer, a broker, a transfer agent, a CEO, a purchaser, or an attorney, does not adequately explain what role the defendant actually played in the scheme at issue."). Although the SEC asserts that Mr. Larsen "ma[de] promotional statements" (Compl. ¶ 403), it fails to allege any specific statements, let alone tie any such statements to any specific sales of XRP. The failure to plead sales with specificity and to link those sales to specific acts of Mr. Larsen renders the aiding and abetting claim deficient as a matter of law. *See SEC* v. *Mudd*, 885 F. Supp. 2d 654, 670–71 (S.D.N.Y. 2014) (noting that, to aid and abet, a defendant must substantially assist "the commission of the *specific crime* in some way") (emphasis added).

The Amended Complaint also fails to plausibly allege that Mr. Larsen provided "substantial assistance" to Ripple with respect to the sales that occurred when Mr. Larsen was no longer CEO and only Executive Chairman of Ripple's Board. The absence of concrete factual allegations for the period from 2017 through 2020—when Mr. Larsen was only Executive Chairman and had limited involvement in Ripple's day-to-day management—is particularly glaring on the face of the Amended Complaint. Only 13 of the 440 paragraphs in the Amended Complaint address Mr. Larsen's role at Ripple after 2016. The SEC merely alleges that "as chairman of the Board, Larsen was consulted on such offers and sales," that he remained a "key decision maker[] and participant[] in, and continued to direct, Ripple's ongoing offering," and that he "continue[d] to communicate with potential and actual XRP investors and Ripple equity shareholders and to participate in certain projects Ripple is pursuing with respect to XRP." (Compl. ¶¶ 75, 76; *see also id.* ¶¶ 113, 138, 140, 160, 168, 199, 218, 224 (discussing involvement in meetings and presentations, "supervising" and "coordinating" RippleWorks sales,[18] obtaining updates on XRP listings, and participating in escrow formation).) Such threadbare, conclusory allegations, entirely devoid of facts and disconnected from the details of any specific sales by Ripple, cannot establish substantial assistance, as they do not even attempt to provide the Court with a plausible theory of how Mr. Larsen attempted to help the sales succeed. And the SEC again fails to specify any particular promotional statements made by Mr. Larsen after January 1, 2017 and to link such statements to any specific Ripple sale.

At bottom, the SEC's allegations do not rise to the level of "substantial assistance" found in other cases. *See Apuzzo*, 689 F.3d at 214 (finding "substantial assistance" plausibly alleged where defendant agreed to participate in violative transactions, negotiated the details of the transactions, extracted agreements to ensure a counterparty's involvement, and approved and signed agreements with other counterparties which he knew were designed to conceal the fraud); *SEC* v. *Wey*, 246 F. Supp. 3d 894, 930 (S.D.N.Y. 2017) (finding "substantial assistance" plausibly alleged where defendant distributed shares, filed misleading information with the SEC, and sent misleading letters to NASDAQ); *SEC* v. *Riel*, 282 F. Supp. 3d 499, 525 (N.D.N.Y. 2017) (finding that defendant substantially assisted company's violations where he personally made misrepresentations on company's website, in oral statements, and in emails).

[18] RippleWorks is a charitable organization co-founded by Mr. Larsen and independent of Ripple.

II. The First Claim for Relief Should Be Dismissed as to Mr. Larsen for Failure to Plead a Domestic Transaction.

The SEC also fails to allege that Mr. Larsen's offers or sales of XRP on "various [trading] platforms" occurred within the United States and are therefore subject to Section 5(a) or (c) of the Securities Act. This deficiency is fatal to the Section 5 claim against Mr. Larsen.

To plead a Section 5 violation, the SEC must adequately allege that *each offer or sale* occurred within the territorial reach of Section 5. The Supreme Court held in *Morrison* v. *National Australia Bank Ltd.*, in the context of a claim under Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"), that Congress did not intend the federal securities laws to reach extraterritorial conduct, establishing a "clear test" meant to "avoid" "interference with foreign securities regulation." 561 U.S. 247, 269 (2010). Under this test, the statute applies only to (1) transactions in securities listed on domestic exchanges and (2) purchases or sales "made in the United States." *Id.* at 269–70.

The Supreme Court made clear that *Morrison*'s holding extends beyond Section 10(b) and the Exchange Act to the securities laws more generally, reasoning that "[t]he same focus on domestic transactions is evident in the Securities Act of 1933, enacted by the same Congress as the Exchange Act, and forming part of the same comprehensive regulation of securities trading." *Id.* at 268 (citation omitted). Accordingly, lower courts have applied *Morrison*'s two-pronged test to claims under the Securities Act, including Section 5 claims. *See SEC* v. *Bio Def. Corp.*, No. 12-11669-DPW, 2019 WL 7578525, at *11–13 (D. Mass. Sept. 6, 2019) (applying *Morrison* to Section 5 claim); *see also Schentag* v. *Nebgen*, No. 1:17-CV-8734-GHW, 2018 WL 3104092, at *10–13 (S.D.N.Y. June 21, 2018) (dismissing Section 5 claim, along with other Securities Act and Securities Exchange Act claims, under *Morrison*).

Under the *Morrison* test, the SEC has the burden of pleading and proving the domesticity of *each contested transaction*. *See SEC* v. *Ahmed*, 308 F. Supp. 3d 628, 660 (D. Conn. 2018) (noting that the "SEC must prove" domesticity "as to each transaction at issue"); *see also In re Petrobras Sec.*, 862 F.3d 250, 271–74 (2d Cir. 2017) (holding that the *Morrison* inquiry is "individualized"); *Mori* v. *Saito*, No. 10 CIV. 6465 (KBF), 2013 WL 1736527 at *5–7, (S.D.N.Y. Apr. 19, 2013) (designating certain transactions as adequately pleaded, but not others, for purposes of domesticity). This is particularly important when the SEC is alleging that the "core" of its case is that "each sale is a violation if it is not made pursuant to a registration statement or qualifies for an exemption." Hr'g Tr. 43:10–23 (Mar. 19, 2021). And yet, despite a two-and-a-half year investigation into Mr. Larsen's offers and sales of XRP and its allegation that Mr. Larsen sold over $450 million in XRP, the SEC fails to identify ***even one*** offer or sale of XRP by Mr. Larsen in the United States. And the SEC implicitly admits in its Amended Complaint that it cannot do so for virtually all of the transactions, acknowledging that Mr. Larsen "at times paid [a global digital asset trading firm] to make offers and sales of his XRP on digital asset trading platforms *with worldwide operations and customers*" (Compl. ¶¶ 96, 174) (emphasis added) and that he "offered and sold to investors all over the world" (*id.*). The SEC's failure to allege specific offers and sales of XRP is fatal to its claim.

A. The SEC Fails to Plead Any Sales Were Domestic Pursuant to *Morrison*

The SEC does not plead that any of Mr. Larsen's XRP sales occurred on a domestic exchange. Thus, under *Morrison*, the question is whether they were otherwise "made in the United States." *See* 561 U.S. at 270. A transaction is "made in the United States" when "irrevocable liability was incurred or title was transferred within the United States." *Absolute Activist Value Master Fund Ltd.* v. *Ficeto*, 677 F.3d 60, 68 (2d Cir. 2012). Critically, "the mere assertion that transactions 'took place in the United States' is insufficient to adequately plead the existence of domestic transactions." *Id.* at 70. Instead, courts require "facts concerning the formation of the contracts, the placement of purchase orders, the passing of title, or the exchange of money." *Banco Safra S.A. Cayman Islands Branch* v. *Samarco Mineracao S.A.*, 19-3976-cv, 2021 WL 825743, at *2 (2d Cir. Mar. 4, 2021). The inquiry focuses on "the time when the parties to the transaction are committed to one another . . . [where] there was a meeting of the minds of the parties." *Arco Cap. Corps. Ltd.* v. *Deutsche Bank AG*, 949 F. Supp. 2d 532, 542 (S.D.N.Y. 2013) (quoting *Absolute Activist*, 677 F.3d at 67–68).

Sales completed on foreign exchanges are not captured by Section 5(a). *See In re Vivendi Universal, S.A. Sec. Litig.*, 765 F. Supp. 2d 512, 532–33 (S.D.N.Y. 2011) (dismissing claims of American shareholders who purchased shares on a foreign exchange, reasoning that *Morrison* "clearly sought to bar claims based on purchases and sales of foreign securities on foreign exchanges . . ."); *see also Holsworth* v. *BProtocol Found.*, No. 20 CIV. 2810 (AKH), 2021 WL 706549, at *3 (S.D.N.Y. Feb. 22, 2021) (dismissing Section 5 claim under *Morrison* where plaintiff in Wisconsin purchased digital coins on digital exchange in Singapore). In determining whether "irrevocable liability" was incurred on foreign exchanges, courts often examine where the matching of orders took place. *See Myun-Uk Choi* v. *Tower Rsch. Cap. LLC*, 890 F.3d 60, 67–68 (2d Cir. 2018) (analyzing Amended Complaint's allegations regarding where the matching of buy and sell orders took place).

The Amended Complaint is devoid of facts showing that "irrevocable liability was incurred" in the United States. Again, no specific transactions are pleaded. The SEC even acknowledges that Mr. Larsen sold his XRP through a foreign market maker "on digital asset trading platforms with worldwide operations and customers," "through certain digital asset trading platforms whose parent corporations are located outside the United States," and "to investors all over the world." (Compl. ¶¶ 174, 177.) The SEC attempts to allege domesticity simply by claiming that Mr. Larsen (i) "directed his . . . sales of XRP from within the United States" (*id.* ¶ 176); (ii) made . . . sales of XRP to persons in the United States" (*id.* ¶ 178); (iii) "sold his XRP to investors . . . in the United States" (*id.* ¶ 174); (iv) "opened his account with at least one . . . United States-based wholly owned subsidiary" of a foreign exchange (*id.* ¶ 177); (v) made sales that "occurred on" certain platforms either incorporated or with their principal places of business in the United States (*id.*). The SEC also claims that "resources located in the United States" were used to execute Mr. Larsen's trades, (*id.*), and vaguely alludes to a risk of XRP being sold back into the United States market. (*See id.* ¶ 174.) These conclusory allegations, however, devoid of any specific transactions, are insufficient to allege a domestic transaction.

First, the SEC cannot adequately plead domesticity by alleging that Mr. Larsen directed orders from the United States or by alleging that purchasers were located in the United States because that is irrelevant to where "irrevocable liability" is incurred. *Plumbers' Union Local No. 12 Pension Fund* v. *Swiss Reinsurance Co.*, 753 F. Supp. 2d 166, 178 (S.D.N.Y 2010) ("Accordingly, as a general matter, a purchase order in the United States for a security that is sold on a foreign exchange is insufficient."); *see also City of Pontiac*, 752 F.3d at 181 (likewise finding it insufficient to allege that a U.S. entity "placed a buy order [of a foreign security] in the United States that was then executed on a foreign exchange."); *Loginovskaya* v. *Batratchenko*, 764 F.3d 266, 275 (2d Cir. 2014) ("The direction to wire transfer money to the United States is insufficient to demonstrate a domestic transaction" because the wire transfers "were actions needed to carry out the transactions, and not the transactions themselves."); *Absolute Activist*, 677 F.3d at 69 ("[A] purchaser's citizenship or residency does not affect where a transaction occurs; a foreign resident can make a purchase within the United States, and a United States resident can make a purchase outside the United States.").

Second, the mere assertion that offers or sales occurred on platforms either incorporated or with their principal places of business in the United States (*see* Compl. ¶ 177) is similarly deficient because Second Circuit courts have made clear that it is not "enough to allege that a United States entity was involved in a transaction." *See Banco Safra*, 2021 WL 825743 at *2 (noting that the "physical location of a broker-dealer involved in the relevant transaction does not necessarily demonstrate where a contract was executed"). For similar reasons, the allegations regarding the opening of accounts says nothing about where Mr. Larsen's sales took place.

Finally, while the SEC alludes to a risk that Mr. Larsen's XRP will be sold back into the United States (*see* Compl. ¶ 174), that risk does not transform a foreign transaction into a domestic transaction. The SEC fails to assert that this has *in fact* occurred with respect to the XRP sold by Mr. Larsen, or that *any* XRP purchased on overseas exchanges has been resold in the United States. Accordingly, the Section 5(a) claim against Mr. Larsen should be dismissed. *See Sullivan*, 2017 WL 685570 at *29 (S.D.N.Y. Feb. 21, 2017) (dismissing CEA claim under Morrison where complaint made "no allegations concerning the location of the transactions themselves or the structure of [the] transactions").

B. The SEC Fails to Plead Any Offers Were Domestic Pursuant to *Morrison*

Having failed to plead domestic sales of XRP, the SEC resorts to claiming that Mr. Larsen is nevertheless liable under Section 5(c) of the Securities Act of 1933 because, even if his sales were foreign, his *offers* of XRP were domestic. But this claim is equally deficient.

The SEC's central allegation in this regard is that Mr. Larsen's offers "occurred on various digital asset trading platforms," that he "offered . . . his XRP to investors all over the world" on trading platforms, and that he "at times paid [a] Market Maker to make offers . . . of his XRP on digital asset trading platforms with worldwide operations and customers." (Compl. ¶¶ 174, 177.) Tellingly, the SEC does not allege that the offers on those platforms were made within the United States, and thus the only plausible inference is that those offers took place on foreign exchanges. But the Supreme Court made clear in *Morrison* that the federal securities laws were not intended by Congress to regulate foreign securities exchanges. *Morrison*, 561 U.S. at 267–68 (explaining that "no one . . . thought that the [Exchange] Act was intended to 'regulat[e]' *foreign* securities exchanges" and "[t]he same focus on domestic transactions is evident in the Securities Act of 1933"). The Amended Complaint's other allegations—that Mr. Larsen "directed his offers . . . of XRP from within the United States" and "made offers . . . to persons in the United States" (Compl. ¶¶ 176, 178)—are wholly conclusory and should be disregarded. *See Absolute Activist*, 677 F.3d at 70 (rejecting conclusory allegations).

In an attempt to distract from the deficiency of its allegations and the mandate of *Morrison*, the SEC relies on Regulation S—a regulation promulgated by the SEC prior to *Morrison* to exempt certain foreign securities offerings from registration. *See* Letter from Jorge G. Tenreiro, ECF No. 56, at 4 (Mar. 10, 2020). The SEC cannot use its regulations to extend the federal securities laws' reach in a manner inconsistent with Congress's intent. *Food & Drug Admin.* v. *Board & Williamson Tobacco Corp.*, 529 U.S. 120 (2000) (agency cannot regulate inconsistent with intent of Congress). *Morrison* demonstrates that Congress did not intend federal securities laws to be enforced extraterritorially. Thus, the SEC's allegations do not survive under *Morrison*, and Regulation S cannot revive them.

C. Mr. Larsen's Sales and Offers Were "Predominantly Foreign"

Even if the SEC adequately pleaded that Mr. Larsen's sales and offers were domestic pursuant to the Supreme Court's decision in *Morrison*, which it has not, the Section 5 claim should nevertheless be dismissed because—as evident on the face of the Amended Complaint—

Mr. Larsen's sales and offers were "predominantly foreign" under the Second Circuit's decisions in *Parkcentral Glob. Hub Ltd.* v. *Porsche Auto. Holdings SE*, 763 F.3d 198 (2d Cir. 2014) and *Cavello Bay Reinsurance Ltd.* v. *Shubin Stein*, 986 F.3d 161 (2d Cir. 2021).

These cases make clear that domesticity pursuant to *Morrison* is "necessary but not necessarily sufficient" to subject transactions to federal securities laws, and such transactions may still fall outside the reach of the federal securities laws if they are "so predominantly foreign so as to be impermissibly extraterritorial." *Parkcentral*, 763 F.3d at 216; *Cavello Bay*, 986 F.3d at 166–67. Here, it is evident on the face of the Amended Complaint that Mr. Larsen's offers and sales were "predominantly foreign." The Amended Complaint concedes that Mr. Larsen "offered and sold his XRP to investors all over the world" and "paid the Market Maker to make offers and sales of his XRP on digital asset trading platforms with worldwide operations and customers." (Compl. ¶ 174.) And, by contrast, the Amended Complaint asserts only vague references to domesticity. The SEC's failure to plead specific domestic offers and sales is fatal to its claims.

III. The SEC's Claims for Monetary Relief Are Time-Barred

Because the SEC has chosen to frame its case as a single continuing violation of Section 5 of the Securities Act, its claims against Mr. Larsen for over $450 million in disgorgement and civil monetary penalties accrued more than five years prior to September 1, 2020[19] and are therefore barred by the statute of limitations set forth in 28 U.S.C. § 2462.[20]

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[19] Mr. Larsen and the SEC entered into a tolling agreement suspending the running of the statute of limitations between September 1, 2020 and the time the initial Complaint was filed. While Mr. Larsen reserves his rights to challenge the tolling agreement, that issue is not relevant to Mr. Larsen's motion to dismiss.

[20] The SEC informed Defendants by email dated January 21, 2020, that "[t]he SEC will not assert, in this case, that the statute of limitations of the National Defense Authorization Act of 2020 ('NDAA') applies to any of the claims asserted by the SEC in this case."

Pursuant to 28 U.S.C. § 2462, an action "shall not be entertained unless commenced within five years from the date when the claim first accrued." A claim first accrues when "the plaintiff has a complete and present cause of action." *Gabelli* v. *SEC*, 568 U.S. 442, 448 (2013). Where a claim alleges a violation involving the offering or sale of unregistered securities, it accrues at the beginning of the alleged offering or sale. *See SEC* v. *Jones*, 300 F. Supp. 3d 312, 315–18 & n.4 (D. Mass. 2018) (dismissing claims as time-barred because the SEC failed to allege that the defendant offered or sold securities within the five-year limitation period). Where a plaintiff alleges in its complaint that the conduct at issue is "a single violation [that] continue[d] over an extended period of time," rather than "conduct that is a discrete unlawful act," the claim accrues on the start date of the violation. *See Sierra Club* v. *Oklahoma Gas & Electric Co.*, 816 F.3d 666, 671–75 (10th Cir. 2016). A statute of limitations defense may be decided on a motion to dismiss "if the defense appears on the face of the complaint." *Ellul*, 774 F.3d at 798 n.12.

Despite investigating Ripple and Mr. Larsen for over two and a half years before filing its initial Complaint, obtaining Mr. Larsen's XRP trading records, and having every opportunity to identify each offer and sale for which it seeks monetary relief, the SEC fails to allege *any* discrete XRP offers or sales. Rather, the SEC—perhaps in an effort to evade its obligation to allege the domesticity of each individual offer or sale (see *supra* Section II) or to prevent Defendants from making arguments about the applicability of specific exemptions—alleges that Defendants engaged in a "years-long unregistered offering of securities," lasting "[f]rom at least 2013 through the present," and seeks over half a billion dollars in disgorgement. (Compl. ¶¶ 1, 5.) The SEC defines this "years-long unregistered offering of securities" as "the Offering," (*id.* ¶ 5), and uses this defined term throughout the entirety of its Amended Complaint. (*See id.* ¶¶

19, 73–75, 82, 85, 97, 190, 193, 196, 231, 239-241, 245, 250, 273, 287, 290, 293, 317, 342, 375–377, 383, 392, 395, 403, 423, 432.)

The natural result of the SEC's own pleading is that its claims for disgorgement and civil monetary penalties accrued in 2013, rather than 2015 as the SEC alleges, and thus its claims are now time barred. This result makes sense. Despite the fact that the underlying conduct at issue in "the Offering"—unregistered sales of XRP—occurred throughout this period, the SEC waited nearly eight years to bring this action. For those eight years, the SEC permitted a thriving XRP open market to grow to trade billions of dollars daily and allowed millions of market participants without any relation to Ripple to purchase XRP. It should not now be permitted to claim relief.

To the extent the SEC asks this Court in its opposition brief to rewrite the Amended Complaint to allege discrete violations, this Court should decline to do so. A theory of "'discrete,' 'repeated,' or 'multiple'" violations must be plainly alleged in the complaint. *See Clarke* v. *Pac. Gas & Elec. Co.*, No. 20-CV-04629-WHO, 2020 WL 6822912 at *9 (N.D. Cal. Nov. 20, 2020) (finding claim time barred, noting that "[c]ounsel for [Plaintiff] spent much time at the hearing explaining how [Plaintiff's] claims involve[d] multiple discrete violations . . . but the fact of the matter is that the Complaint, on its face, does not make those allegations"). The SEC has already amended its Complaint once, and like any other plaintiff, the SEC controls how it chooses to plead its claims and must live with the consequences. The SEC's claims for civil monetary fines and disgorgement against Mr. Larsen should therefore be dismissed with prejudice as time-barred.

CONCLUSION

For the foregoing reasons, the Amended Complaint should be dismissed with prejudice as to Mr. Larsen.

Dated: New York, New York
April 12, 2021

Respectfully submitted,

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UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION,	:	
Plaintiff,	:	**20 Civ. 10832 (AT) (SN)**
- against -	:	**ECF Case**
RIPPLE LABS, INC., BRADLEY GARLINGHOUSE, and CHRISTIAN A. LARSEN,	:	
Defendants.	:	

PLAINTIFF SECURITIES AND EXCHANGE COMMISSION'S MEMORANDUM OF LAW IN OPPOSITION TO DEFENDANTS CHRISTIAN A. LARSEN'S AND BRADLEY GARLINGHOUSE'S MOTIONS TO DISMISS

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May 14, 2021

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Plaintiff Securities and Exchange Commission ("SEC") respectfully submits this memorandum of law in opposition to Defendants Christian A. Larsen's ("Larsen") and Bradley Garlinghouse's ("Garlinghouse," together "Defendants") motions to dismiss (D.E. 105, 110) ("Motions") the SEC's First Amended Complaint (D.E. 46, the "Complaint"), in accordance with the Court's Order (D.E. 154). For the reasons set forth below, the Court should deny the Motions.[1]

PRELIMINARY STATEMENT

The Complaint alleges that Larsen, the co-founder and first chief executive officer ("CEO") of California-based co-defendant Ripple Labs, Inc. ("Ripple"), and Garlinghouse, Ripple's current CEO, offered and sold a digital asset issued by Ripple, known as "XRP," as a security. Defendants did not register these offers and sales with the SEC, as Congress required in Section 5 of the Securities Act of 1933 ("Securities Act") to provide investors with important information to decide whether to invest in a security. Defendants do not contend that the Complaint fails to adequately allege that they or Ripple offered and sold XRP as "a security." Thus the Court should assume that Ripple and Defendants did so for purposes of the Motions.

Over several years, Larsen and Garlinghouse profited by at least $450 million and $159 million, respectively, from their own unlawful sales of XRP. Defendants' sales were an integral part of Ripple's broader scheme to distribute as much XRP into global markets as possible, including to investors in the United States and including through U.S. digital asset trading platforms, *i.e.*, "exchanges" for electronically trading digital assets. Ripple's sales, which Larsen and Garlinghouse directed, netted Ripple an additional $1.38 billion.

Larsen and Garlinghouse engaged in this conduct despite repeated warnings that Ripple's and their own offers and sales of XRP would likely violate the federal securities laws. Before XRP even existed, a reputable law firm warned Larsen in two legal opinions that Ripple's and Larsen's

[1] References to "¶ __" are to the Complaint. "Ex. [ ]" refers to the Exhibits attached to the Declaration of Jorge G. Tenreiro, filed herewith. "Larsen Br." refers to the brief in support of Larsen's Motion (D.E. 106) and "Garlinghouse Br." to the brief in support of Garlinghouse's Motion (D.E. 111).

offers and sales of XRP could require registration with the SEC under certain circumstances. Larsen then proceeded to direct Ripple's and his own offers and sales of XRP in a manner that the law firm had specifically warned against doing. As Larsen later acknowledged in an email, he did so because Ripple was paying him XRP potentially worth hundreds of millions of dollars to knowingly assume the legal risk that the SEC would hold him responsible for these unlawful sales. Similarly, multiple advisors and public SEC statements about the sales of digital assets had warned Garlinghouse of the risk that Ripple's offers and sales of XRP could be deemed to be offers and sales of securities.

Nevertheless, Defendants directed and furthered Ripple's years-long venture to create and manage an active, stable trading market for XRP to increase its value, in addition to engaging in their own sales of XRP. They approved the timing, amount, and manner of Ripple's XRP offers and sales to private and public investors. And they promoted XRP as a potentially lucrative investment from which investors could profit based on efforts they promised Ripple would undertake.

The Complaint alleges that Defendants and Ripple violated Section 5 of the Securities Act through their own respective offers and sales of XRP. The Complaint further alleges that Defendants aided and abetted Ripple's violations of Securities Act Section 5. In response to these allegations, Defendants move to dismiss on several grounds.

First, Defendants move to dismiss the aiding-and-abetting claim against them on the ground that the Complaint fails to adequately allege that they knowingly or recklessly aided Ripple's violations of Section 5. Ignoring the extensive factual allegations that Defendants understood (or, at a minimum, recklessly disregarded) the legal consequences of their conduct, Defendants invite the Court to set aside these allegations and reach evidentiary conclusions about their state of mind—an improper exercise on a motion to dismiss.

Second, Larsen alone moves to dismiss the aiding-and-abetting claim on the ground that the Complaint fails to allege that he substantially assisted Ripple's violations of Section 5. Again, Larsen asks the Court to ignore the detailed allegations that he directed and assisted Ripple's scheme to distribute as much XRP into the domestic and global markets as possible, including through his own XRP offers and sales and through steps he took to direct Ripple's XRP marketing and sales.

Third, Defendants move to dismiss on the ground that the unlawful offers and sales of XRP—which took place from the U.S., were marketed to U.S. investors, were offered and sold in part through U.S. trading platforms, and were in fact sold to U.S. investors—were not "domestic" U.S. offers and sales covered by Securities Act Section 5. Defendants argue that the conduct alleged is instead "extraterritorial" and thus foreign conduct under *Morrison v. National Australia Bank*, 561 U.S. 247 (2010) ("*Morrison*"), and therefore not prohibited by Section 5. Defendants misread *Morrison*'s holding. To determine whether an alleged violation of a statute is domestic or extraterritorial, *Morrison* requires courts to analyze the statute to determine what conduct the statute seeks to regulate and what interests it seeks to protect. 561 U.S. at 267. Here, the Securities Act's proper focus is on the entire offering process by which securities flow from the hands of issuers (like Ripple) and their affiliates (like Defendants) to the hands of public investors in the market. Properly understood, nearly every single aspect of Defendants' violations occurred in the U.S. Indeed, as *Morrison* recognized, an SEC regulation, Regulation S, has long defined what constitutes a foreign offering that falls outside the domestic scope of Section 5. The Complaint alleges that Defendants and Ripple did not meet the requirements of that regulation, as Defendants do not dispute, and therefore their conduct was domestic, not extraterritorial.

Finally, Larsen moves to dismiss on the ground that the Complaint's requests for monetary relief against him—based on conduct that continued up until the filing of the Complaint—are time-barred. That argument, too, has no merit.

For these reasons, as discussed more fully below, Defendants' Motions should be denied.

BACKGROUND: LEGAL FRAMEWORK AND DIGITAL ASSETS

Congress enacted the Securities Act as a broad regime of full and fair disclosure, requiring an issuer (for example, a corporation that issues securities) and its control persons who offer and sell securities to the investing public to provide sufficient accurate information to allow investors to make informed investment decisions. ¶¶ 25-26. The Securities Act requires the registration of both offers and sales of an issuer's securities by the issuer and its affiliates (such as a corporation's control persons) into public markets, but exempts from registration ordinary trading transactions in the market by public investors. ¶¶ 27-29.

The definition of "securities" under the securities laws is broad and flexible. It includes "investment contracts," defined by *SEC v. W.J. Howey Co.* as an investment of money into a common enterprise with a reasonable expectation of profit from the efforts of others. 328 U.S. 293, 299, 301 (1946) ("*Howey*"). Courts have found that novel investment schemes are "investment contracts," including when they involve interests in land, animals, and online-only enterprises.

Many courts have found the existence of "investment contracts" with respect to schemes involving the offer and sale of "digital assets." "Digital assets" are assets represented by computer code and transferred on a "distributed ledger" and may be colloquially referred to as "virtual currencies," "cryptocurrencies," and digital "tokens" or "coins." ¶ 32. A "distributed ledger" or "blockchain" is a database spread across a network of computers. It records data and the changing states of the information in the ledger in theoretically unchangeable data packages (or "blocks") and typically relies on cryptography for security. ¶¶ 33-34. The "digital assets" that may be represented on such ledgers may also be "traded" on digital asset trading platforms, for other digital assets, or for fiat currency (legal tender). The digital assets may be allocated to the purchasers' accounts in the record of the platform (*i.e.*, "off-chain"), or they may also be transferred from one blockchain "address" to another, representing the change in ownership of the asset (*i.e.*, "on-chain"). ¶ 35.

STATEMENT OF FACTS[2]

I. BACKGROUND: RIPPLE, LARSEN, AND GARLINGHOUSE

Larsen co-founded Ripple in September 2012 as a Delaware corporation principally based in California. ¶ 16. Larsen served as Ripple's CEO from September 2012 through December 2016, and since then has served as executive chairman of Ripple's Board of Directors. ¶ 18. Garlinghouse served as Ripple's chief operating officer ("COO") from April 2015 through December 2016 and has served as Ripple's CEO from January 2017 to the present. ¶ 17. From 2015 through at least March 2020, Larsen and his wife sold more than 1.7 billion XRP to public investors for at least $450 million. ¶ 86. On December 13, 2016, Ripple granted Garlinghouse 500 million XRP in a negotiated compensation agreement and, on May 29, 2019, granted him an additional 250 million XRP. ¶¶ 128, 129. From April 2017 through at least October 2020, Garlinghouse profited by approximately $159 million from his own sales of XRP. ¶¶ 87, 183.

II. RIPPLE OFFERED AND SOLD SECURITIES WITHOUT A REGISTRATION STATEMENT.

From 2013 to the filing of the Complaint, Ripple engaged in unregistered offers and sales of securities. ¶ 9. Ripple used the means and instrumentalities of interstate commerce to offer and sell XRP to investors in the U.S., without a registration statement being filed or in effect. ¶¶ 392-94. Ripple raised at least $1.38 billion by selling XRP without providing investors—including retail investors, in whose hands Ripple's securities ultimately came to rest—the type of financial and managerial information typically provided in such statements by hundreds of issuers every year. *Id.*

Throughout the relevant time period, Ripple offered and sold XRP as part of "investment contracts" and thus "securities" under the Securities Act. *E.g.*, ¶¶ 230-31, 241-42, 289-94, 315.

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[2] This section sets forth only the facts relevant to the Motions, which are drawn from the factual allegations in the Complaint, documents incorporated by reference in the Complaint, and an SEC order the Court may take judicial notice of. *See Walker v. Thompson*, 404 F. Supp. 3d 819, 823 (S.D.N.Y. 2019); *see also Sullivan v. Barclays PLC*, No. 13 Civ. 2811, 2017 WL 685570, at *21 (S.D.N.Y. Feb. 21, 2017) (taking judicial notice of government settlement).

Among other things, Ripple and its executives promoted XRP as an investment into a common enterprise that would increase in value and price based on Ripple's efforts. ¶¶ 104, 111, 232, 238-44, 290-357. This included taking steps to control the supply and price of XRP and creating an active and liquid trading market for XRP—that is, a market in which investors could quickly and easily buy and sell XRP. ¶¶ 230-357. Ripple offered and sold XRP to raise the capital it needed to fund its operations. ¶¶ 293-301. Indeed, from 2013 through 2020, almost all of Ripple's revenues came from sales of XRP to investors. ¶¶ 1, 5, 61, 70-72, 81.

III. DEFENDANTS KNEW OR RECKLESSLY DISREGARDED THE UNLAWFUL NATURE OF RIPPLE'S OFFERS AND SALES OF XRP.

A. Larsen Received and Ignored Specific Warnings that Offers and Sales of XRP Could Constitute Offers and Sales of Securities.

1. Larsen Has Experience with SEC Claims of Section 5 Violations.

This case is not the first time one of Larsen's businesses has faced SEC claims that the business made unregistered offers and sales of securities in violation of Securities Act Section 5. In 2005, Larsen co-founded, and through 2011 served as the CEO of, Prosper Marketplace, Inc. ("Prosper"), against which the SEC instituted settled administrative proceedings in November 2008 for violating Section 5. ¶ 18; *see also* Ex. A (Order Instituting Proceedings, Rel. No. 33-8984 (Nov. 24, 2008)) ("Prosper Order") at 1, 2, 6. Prosper—presumably through Larsen, the company's then-CEO, or with his approval—consented to the entry of this order, without admitting or denying the order's non-jurisdictional findings. Ex. A at 1, 2, 6. The order found that Prosper's creation of an online marketplace, through which it offered and sold "notes," involved the offers and sales of "investment contracts" and thus "securities" under the Securities Act and the *Howey* test, Ex. A at 4.

2. Larsen Received Two Legal Memos [redacted].

In 2012—before Ripple or Defendants had sold any XRP to investors, ¶ 50—Larsen and other Ripple executives received two memos from a reputable law firm. ¶¶ 52, 56. The memos analyzed [redacted] with distributing "Coins" or "Ripple Credits," as XRP was then known. Ex. B (the "February 2012 Memo") at 1; Ex. C (the "October 2012 Memo" and, with the February 2012 Memo, the "Legal Memos").

The Legal Memos [redacted]. In its summary, the February 2012 Memo [redacted] Ex. B at 2. The summary [redacted]. *Id.* [redacted] *Id.* Accordingly, the February 2012 Memo's [redacted] *Id.* at 4.[3]

In the February 2012 Memo's body, [redacted]. *Id.* at 9. [redacted].

First, the February 2012 Memo [redacted] *Id.* at 9-10 & n.25.

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[3] [redacted] *Id.* at 3.

Second, [redacted] *Id.* at 10 & n.26 [redacted]).

Third, the memo made clear that, [redacted] *Id.* at 10. The memo explained [redacted] *Id.* at 10 & n.32 [redacted]).

Fourth, the February 2012 Memo concluded that [redacted] *Id.* at 11.

In October 2012, Larsen received a second memo from the same law firm, the October 2012 Memo. [redacted] and reiterated many of the February 2012 Memo's conclusions. Based on new information, the memo assumed that [redacted] Ex. C at 3. However, even assuming that [redacted]

[redacted]

Id. at 4.

Like the February 2012 Memo, the October 2012 Memo [redacted]. *See id.* at 15-18. In relevant part, the October 2012 Memo noted that Ripple [redacted] *Id.* at 17. The memo further noted that [redacted]" *Id.* And, again like the February 2012 Memo, the October 2012 Memo [redacted] *id.* at 17-18, and (2) [redacted] *Id.* at 12-13, 18-19.

Finally, the October 2012 Memo included at least two [redacted]. First, the memo [redacted]" Ex. C at 7. The memo therefore advised [redacted]

[redacted] *Id.* at 16. Second, the [redacted] *Id.* at 4, 18; *see also* D.E. 131 at 7 n.3 (explaining "no-action letters").

By at least 2013, Larsen was aware of the contents of the Legal Memos. ¶ 56. In May 2014, Larsen acknowledged in an email that he had received the advice in the Legal Memos. ¶ 57. In an email, he explained that the lawyers who wrote the Legal Memos [redacted] *Id.*; *see also* Ex. E.

3. Larsen Knew or Recklessly Disregarded that XRP Was Being Offered and Sold in the [redacted].

Larsen knew all the facts that made Ripple's offers and sales of XRP the offers and sales of securities under *Howey*, and he knew or recklessly disregarded the legal consequences of these facts [redacted]. *First*, Larsen knew that, [redacted], Ripple was in fact selling XRP for consideration to investors—both because he orchestrated certain such sales and because he made his own. ¶¶ 73, 89, 92, 98, 101-02, 112, 113, 171-79. *Second*, given his involvement in the founding of Ripple when XRP was created, and his own promotional statements touting the common interest between Ripple and all other XRP holders, Larsen knew that there was a common enterprise between himself, Ripple, and all other XRP holders, [redacted] ¶¶ 38, 42, 44-46, 90, 293-94, 300, 313. *Third*, Larsen knew or recklessly disregarded that investors purchased XRP as an [redacted] ¶¶ 232, 397. For example, on February 6, 2017, Larsen acknowledged to an "early investor in XRP" Larsen's own view that most XRP trading was speculative: "Most volume in the space is speculation in advance of enterprise and eventually consumer flows." ¶ 389; Ex. F at 4, 5. *Fourth*, Larsen knew or recklessly disregarded that XRP investors had a reasonable expectation of profit from Ripple's efforts—indeed, he fueled such expectations with his own actions and statements. ¶¶ 242, 246, 289.

4. Larsen Received Additional Warnings that XRP Was a Security.

[redacted], Larsen received additional warnings that XRP could be subject to the federal securities laws, including because XRP was not a "currency" and because, even if it was, it could still be a security under the federal securities laws. ¶ 399. On November 11, 2013, Ripple's accountants sent Larsen a draft memo regarding certain U.S. tax considerations for Ripple and XRP. ¶ 400. The memo explained that XRP was likely not currency under federal income tax laws, principally because XRP "is not considered legal tender in the U.S." *Id.* The memo also explained that "'virtual' currency" like XRP was not traditional currency under guidance issued by the Financial Crimes Enforcement Network ("FinCEN") because XRP was not legal tender in any jurisdiction. *Id.*

On January 5, 2015, the head of an entity looking to establish a private investment fund for XRP forwarded to Larsen an email from the fund's attorney advising that even a virtual currency can be packaged into a security. ¶ 401. On March 9, 2016, while Larsen was CEO, Ripple's attorneys wrote to the New York Department of Financial Services stating that "Ripple consider[s] XRP a digital asset, not a currency," and that "XRP is not intended to be used as a currency." ¶ 402.

B. Garlinghouse Knew or Recklessly Disregarded that Ripple's Offer and Sales of XRP Had the Characteristics of a Securities Offering.

1. Garlinghouse Knew or Recklessly Disregarded the Facts that Made Ripple's Offers and Sales of XRP the Offers and Sales of Securities.

From the outset of his employment at Ripple in 2015 while he was COO, Garlinghouse began to oversee and direct Ripple's decisions about offers and sales of XRP and understood that sales of XRP drove Ripple's revenues. ¶¶ 405, 417. Moreover, at all relevant times, Garlinghouse knew or recklessly disregarded all the facts that make Ripple's offers and sales of XRP the offers and sales of securities, because he actively and repeatedly promoted XRP as an investment of money into a common enterprise with a reasonable expectation of profits from Ripple's efforts. *First*, Garlinghouse knew that both he and Ripple sold XRP for money and other consideration because he specifically approved and directed many such sales. *E.g.*, ¶¶ 98, 101, 104, 110-11, 118, 120, 199, 205, 207, 212, 219. *Second*, Garlinghouse knew that Ripple and all other XRP investors shared a common interest, and he actively touted these common interests and actively encouraged investors to view their economic interests as aligned with Ripple's. *E.g.*, ¶¶ 253, 293, 306-11. *Third*, Garlinghouse knew that investors purchased XRP with an expectation of profit, in part because he himself encouraged such expectations, including by repeatedly touting how he was "very, very, very long XRP." ¶ 347; *see also* ¶¶ 329-30, 334, 336, 338, 342-46, 348-49. In fact, Garlinghouse acknowledged in an October 2019 speech that people are "speculating on digital assets" and that "99.9% of all crypto trading today is just speculation" by profit-seekers, a factor he knew could lead to a determination that XRP was a security. ¶ 421. *Finally*, Garlinghouse knew that investors' expectation of profits were tethered to Ripples' efforts, because he himself promised and touted such efforts, such as by touting Ripple's and its executives' "track record of being good stewards of XRP." ¶ 253; *see also* ¶¶ 242, 254-56, 260-62, 266, 278-79; Ex. G at 2.

2. Garlinghouse Knew or Recklessly Disregarded the Legal Risks.

Garlinghouse knew not only the *facts* of Ripple's underlying violations but also knew or recklessly disregarded the specific legal risks Ripple's conduct entailed. As reflected in his numerous public statements, Garlinghouse understood that the digital asset space entails risks relating to the application of the federal securities laws. ¶ 405. Also, in an email in June 2015, Garlinghouse conceded that Ripple could not distinguish between sales to speculators (investors) and consumers and wrote that it was "not clear to [him]…how one would reasonably discern…between a speculator and a consumer." ¶ 406. Next, on March 11, 2017, Ripple's chief compliance officer ("CCO") explained to Garlinghouse in an email that "XRP certainly has some 'securities-type' characteristics and we do need to hone our playbook/messaging." ¶ 407. On April 16, 2017, he was similarly advised by e-mail that the CCO "want[ed] to make sure the verbiage [in employee offer letters] doesn't put us at risk of XRP sounding like a security." ¶ 408.

In July 2017, the SEC issued the *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO*, where the SEC "advise[d] those who would use…distributed ledger or blockchain-enabled means for capital raising, to take appropriate steps to ensure compliance with the U.S. federal securities laws." 117 S.E.C. Docket 745, 2017 WL 7184670, at *1 (July 25, 2017) ("DAO Report"). Garlinghouse read the report, demonstrating his awareness that the securities laws could apply to the offer and sale of digital assets, and commented on Ripple's website after it was issued: "I say, if it looks like a duck and quacks like a duck then let's regulate it like a duck." ¶ 409. Yet Garlinghouse continued to make XRP sound like a security. ¶¶ 223, 410. For example, Garlinghouse boasted later in 2017 about being "very long" XRP—a term used for stock or other securities holdings to mean that an investor's position will increase in value if the price of the security rises. ¶¶ 7, 347. Garlinghouse made similar comments about being "very long" XRP when Ripple announced in 2017 that it would place 55 billion XRP into an escrow (the "XRP Escrow"), meant to stabilize XRP's price and assuage investor concerns. ¶¶ 223, 410.

Garlinghouse continued to stay abreast of regulatory developments in the digital asset space after the DAO Report because he understood that it was critical to Ripple's business that XRP *not* be deemed a security. On December 11, 2017, for example, Ripple's public relations firm emailed him to notify him to "call…out" a recent statement by the then-SEC Chairman that "[m]erely calling a token a 'utility' token or structuring it to provide some utility does not prevent the token" from being a security, given that it "had been a concern to have XRP considered a security." ¶ 411.

Garlinghouse demonstrated his awareness of some of the facts that could result in offers and sales of XRP being securities and the potential legal ramifications of those facts at other moments. For example, in January 2018, Garlinghouse commented on an internal Ripple draft document that XRP should not be promoted as an investment, ¶ 412, even though he was doing that very thing on Twitter and in other public forums around the time. ¶¶ 306-11. In a Yahoo! Finance interview in February 2018, Garlinghouse acknowledged his understanding that "if there is not a real use case then it's really a securities offering," while knowing or recklessly disregarding that none of Ripple's sales of XRP up to that point were for XRP's "use," other than as an investment. ¶ 413. In the interview, Garlinghouse also characterized "people in the crypto space talking about 'regulatory uncertainty'" as really saying "more often than not that means 'I disagree with the regulatory certainty so I'm going to call it regulatory uncertainty.'" *Id.*

Finally, Garlinghouse was aware of the keen interest other market participants—especially the digital asset trading platforms that Ripple and Garlinghouse had repeatedly tried to get to "list" XRP for trading—had in the regulatory status of XRP under the federal securities laws. At least four digital asset trading platforms incorporated in the U.S. asked Ripple for a legal opinion as to the status of XRP under the federal securities laws. ¶ 415. Garlinghouse knew that a determination that XRP was a security could hurt Ripple's ability to continue raising capital by selling XRP. ¶¶ 416-17. On January 11, 2018, Garlinghouse signed Ripple's application with a digital asset trading platform whose principal place of business is in California ("Platform A") to make XRP available for trading. ¶ 414. The application represented that "[w]e understand that whether or not a digital asset may be considered a security is an important consideration for many in the digital asset ecosystem." *Id.* Shortly afterwards, as Defendants were told in a July 14, 2018 email, at least one other U.S. digital asset trading platform declined to make XRP available for trading on its platform because Ripple could not provide a legal opinion that XRP was not a security under federal law. ¶ 415.

Not surprisingly, given his knowledge as described above, when Garlinghouse (accompanied by Larsen) met with one of Ripple's equity investors in 2018, he told the investor that he could "[ ]not guarantee" that XRP would not be deemed a security by the SEC. ¶ 420.

IV. DEFENDANTS SUBSTANTIALLY ASSISTED RIPPLE'S VIOLATIONS.

A. Defendants Actively Participated in Ripple's Unregistered Public Distribution of Securities with Their Own Offers and Sales of XRP from the United States.

Ripple's lack of funds and its stated business goal of finding a "use" for XRP compelled Ripple to sell as much XRP as possible to fund Ripple's operations, ¶¶ 50, 65-69, 79-91, and create an active, liquid trading market for the asset. ¶¶ 68-71, 83, 89, 190. To inspire investor confidence in this market, Ripple ensured that its sales would not decrease XRP's price. *E.g.*, ¶¶ 193-229.[4] Beginning in 2015, Defendants, while Ripple's affiliates, actively participated in and assisted Ripple in achieving these goals—which Defendants shared with Ripple—by engaging in their own, concurrent offers and sales of XRP, while also ensuring that their sales would not decrease XRP's price. ¶¶ 85-86, 173, 181-82, 188.[5]

1. Defendants Shared Ripple's Goal of Selling as Much XRP as Possible into Markets They Created and Actively Participated in that Endeavor.

Larsen (beginning in 2015) and Garlinghouse (beginning in 2017) directly participated in and assisted Ripple's XRP offering by offering and selling their own holdings of XRP into the open market, typically using the same distribution methods as Ripple. ¶ 85. Between the two of them, Larsen and Garlinghouse profited by more than $600 million from their own XRP sales. ¶¶ 86-87. Defendants' offers and sales of XRP occurred in coordination with Ripple's efforts to develop and maintain a liquid market for XRP. ¶¶ 173, 182. Ripple's offers and sales of XRP took many

[4] Although Garlinghouse has not moved to dismiss the Complaint for failure to plead his substantial assistance (only Larsen has), this section summarizes the Complaint's allegations as to substantial assistance by each of them. This section does so as to Garlinghouse to provide background necessary to explain allegations of his knowledge or recklessness and as to both Defendants to show that Defendants engaged in domestic offers and sales of securities.

[5] Under the Securities Act, an "affiliate" is a person who controls another person or entity. *See* 17 C.F.R. § 230.405.

forms—for example, Ripple used four market makers with a presence in the U.S. to sell to the public, one of which Defendants also used to sell their own XRP to the public. ¶¶ 95-96, 183. Defendants' own offers and sales occurred on at least four U.S.-based digital asset trading platforms and other non-U.S.-based digital asset trading platforms. ¶¶ 177, 186.

Both Defendants tried to maximize their profits from their XRP sales while not depressing the price of XRP. ¶ 173. To do that, they monitored the timing and amount of their XRP sales and purchases, sometimes to coincide with strategic announcements about Ripple or XRP. ¶¶ 173, 182, 190-92. In fact, in an email to an investor, Larsen explicitly explained that his own personal sales of XRP were in line with Ripple's overall goal "to have widely held assets" in the market. ¶ 179.

Larsen directed significant efforts to monitor, manage, and impact the XRP trading markets, including the trading price and volume of XRP. *E.g.*, ¶¶ 193-194, 199, 205, 207, 218. Garlinghouse did the same. ¶¶ 193-194, 199, 205, 207, 211, 212, 218, 219, 220. For example, after consultation with Larsen, Garlinghouse gave the "go ahead" to "keep the buying [of XRP] light [the day after a Ripple news announcement] and then do the bigger slug starting Sunday" in 2016. ¶ 207. Garlinghouse also ensured that Ripple placed restrictions on sales of XRP by Larsen's co-founder to quell concerns that such sales would negatively impact XRP's market trading, ¶ 211, and instructed Ripple employees to "proactively" try to increase speculative trading with positive XRP news. ¶ 212.

2. Defendants' Offers and Sales of XRP Were an Integral Part of Ripple's Public Distribution of XRP.

Both Defendants made unregistered offers and sales of XRP to investors all over the world, including in the U.S., and did not restrict non-U.S. purchasers of their XRP from distributing it to investors in the U.S. ¶ 174 (Larsen); ¶ 184 (Garlinghouse). Both directed their offers and sales of XRP from within the U.S. and to U.S. persons. ¶¶ 176, 178 (Larsen); ¶¶ 184, 187 (Garlinghouse). Both engaged in significant publicity efforts, directed at U.S. markets, regarding the desirability of purchasing XRP as investments, including by posting articles on Ripple's website, Tweeting about

XRP, or giving interviews in Ripple's YouTube channel or U.S. financial news programs. *E.g.*, ¶¶ 113, 174, 177-78, 265, 300 (Larsen); 184, 186-87, 253-256, 261-62, 266, 278-79, 307-11, 326, 337, 345-349 (Garlinghouse); 60, 115-16, 119, 160, 190, 193 (both). Defendants' directed selling efforts into the U.S., in tandem with Ripple's, were marketed and aimed at investors, including U.S. investors. *E.g.*, ¶¶ 197-202, 217, 257-29, 264, 267-68, 271-72, 275, 301, 323-34, 331-36, 340 (efforts by other Ripple executives).

Both Defendants' XRP transactions occurred on a variety of digital asset trading platforms, including four incorporated in the U.S. and a fifth principally based in New York. ¶¶ 177, 186. Defendants also traded XRP on some digital asset trading platforms operated by non-U.S. companies, but, with respect to one such platform, both Defendants opened their accounts with the platform's U.S.-based wholly-owned subsidiary, and, with respect to another such platform, it appears to have used U.S.-based electronic resources to execute Defendants' trades. *Id.*

Even Defendants' other XRP transactions on non-U.S. digital asset platforms had a significant U.S.-based component. XRP are digital assets that exist on a distributed ledger (the XRP Ledger) Ripple created. Ripple or other U.S.-based entities run at least 40% of the "nodes" necessary to operate this blockchain and thus transfer ownership of XRP that changes hands (to the extent the transactions occur "on-chain," meaning transferred from one blockchain address to another). ¶¶ 32-35, 39-41. And, many of these platforms do not restrict access to U.S. persons.

B. Defendants Provided Additional Substantial Assistance to Ripple's Violations.

In addition to assisting Ripple's violations by making their own, parallel, coordinated sales of XRP, *see supra* Section I.A, Defendants substantially assisted Ripple's violations in other ways.

1. Larsen

In addition to his own sales, Larsen provided substantial assistance to Ripple's unregistered offers and sales by developing and implementing strategies to further XRP's distribution, negotiating certain XRP sales, approving decisions to sell XRP into the market, and making promotional statements and speaking to investors about buying XRP. ¶ 403.

a. Larsen Co-Founded Ripple and, as its CEO, Was Responsible for its Strategy.

Ripple was founded with a fixed supply of 100 billion XRP. ¶¶ 44, 45. Shortly after founding Ripple in December 2012, Larsen, with his co-founder and another person, transferred 80 billion XRP to Ripple and the remaining 20 billion XRP to themselves, with Larsen receiving 9 billion XRP. ¶¶ 45, 46. After the transfer, Ripple and its founders controlled 100% of XRP. ¶ 46. Larsen and his co-founder created Ripple to, among other things, distribute XRP. ¶ 47.

As CEO, Larsen ran Ripple's day-to-day operations and was responsible for all aspects of manners and strategy and for the growth of and investment in the company. ¶ 43. Larsen solicited and participated in meetings with current and prospective Ripple equity and XRP investors and regularly updated Ripple's Board of Directors and shareholders. *Id.* As chairman of the Board, Larsen was consulted on the timing and amounts of unregistered offers and sales of XRP. ¶ 76.

b. Larsen Substantially Assisted Ripple in Creating a Market for XRP in the United States and Abroad and in Distributing XRP into those Markets.

From 2013 through 2014, Ripple and Larsen made efforts to create a market for XRP by having Ripple distribute approximately 12.5 billion XRP through "bounty programs" that paid programmers compensation for reporting problems in the XRP Ledger's code. ¶ 61. To do so, Ripple distributed small amounts of XRP (typically between 100 and 1,000 XRP per transaction) to anonymous developers and others to establish a trading market for XRP. *Id.* At the same time, Ripple began to make public statements about XRP that began to create in investors an expectation of profit based on Ripple's efforts. ¶¶ 62-63.

By at least late 2013, Ripple and Larsen viewed the "Goal of Distribution" for XRP as achieving "Network Growth" and "Rais[ing] funds for Ripple Labs operations," as reflected in at least one internal Ripple document entitled the "XRP Distribution Framework." ¶ 65. In August 2013, Ripple started making unregistered offers and sales of XRP in exchange for fiat currencies or digital assets such as Bitcoin. ¶ 72. Larsen orchestrated the initial stage of Ripple's unregistered offers and sales of XRP by approving the timing and amount of offers and sales to: (1) purchasers in the open market ("Market Sales"); (2) investment funds, wealthy individuals, or other sophisticated investors ("Institutional Sales"); and (3) others enlisted to assist Ripple's efforts to develop an XRP market (the "Other XRP Distributions"). ¶ 73. From 2013 through 2019, to fund its operations, Ripple sold at least 3.9 billion XRP through Market Sales for approximately $763 million. ¶ 80. From 2013 through the end of the third quarter of 2020, Ripple sold at least 4.9 billion XRP through Institutional Sales for approximately $624 million, also to fund Ripple's operations. ¶ 81. Since 2013, Ripple has disbursed at least 4.05 billion XRP (valued at least $500 million) through Other XRP Distributions. ¶ 84.

Market Sales. As CEO, Larsen initiated and approved Ripple's Market Sales of XRP. ¶ 92. While he was CEO, Larsen had and exercised final decision-making authority over which trading venues (such as which digital asset platform) to use for Market Sales and how much XRP to sell on a particular venue, which Ripple typically set as an overall percentage of XRP's daily trading volume. ¶ 98. As Ripple explained in June 2018 to a New York-based investment firm when the firm was considering the creation of an XRP-based fund, the "XRP Sales Committee consisting of Brad Garlinghouse (CEO), Chris Larsen (Co-founder and Executive Chairman)" and two other individuals at Ripple "make[ ] XRP distribution and sales decisions at the company." ¶ 75. Ripple conducted the Market Sales by paying at least four entities commissions, paid in XRP, for executing Ripple's XRP sales to the public on digital asset trading platforms, mostly through a global digital asset trading firm with a U.S. office (the "Market Maker"). ¶¶ 95, 96.[6]

[6] A "market maker" is a firm that stands ready to buy or sell a security at publicly quoted prices.

Ripple employees or the Market Marker sought Larsen's approval as to parameters for conducting Ripple's Market Sales. ¶ 100. For example, in mid-December 2015, Ripple's then-chief financial officer (the "CFO") informed Larsen and Garlinghouse that the Market Sales had been paused due to a drop in XRP price but suggested the following day that the sales be restarted. Larsen instead instructed the CFO to "keep paused for now" and "[w]ait until [the] market had recovered from this mistake," though he approved re-starting sales once he learned XRP's price had stabilized. *Id.* Similarly, in April 2016, the CFO emailed Larsen and Garlinghouse about continued "downward pressure on the price of XRP" and suggested having the Market Maker "adjust down a bit our net sell target for a few days to see if we can help stabilize and/or increase the XRP price." ¶ 101. Larsen responded, "Yes – let's adj[ust]."

Institutional Sales. Since at least 2013, Ripple and Larsen oversaw Institutional Sales to obtain essential funding for Ripple's operations and develop a speculative trading market in XRP. ¶ 102. Larsen played a significant role in negotiating and approving Ripple's Institutional Sales and other offers and sales of XRP to institutional investors. ¶ 110. For example, Larsen: (1) in April 2016, approved the sale of XRP to an institutional investor that describes itself as a "full-service digital currency prime broker.," who ultimately bought approximately 115 million XRP, ¶¶ 115-16; (2) in 2016, signed an agreement with a firm giving it an option to buy up to 5 billion XRP at a discounted price in exchange for efforts to help Ripple develop a "use" for XRP, ¶ 153; and (3) in 2017, Larsen met with "a $12B [$12 billion] alternative asset hedge fund" that bought approximately 14.8 million XRP, ¶¶ 113-14.[7]

c. Larsen Substantially Assisted Ripple by Promoting XRP.

Larsen was involved in efforts to promote XRP while and after he was CEO. ¶ 168. In a February 19, 2014 interview posted online, Larsen explained that one of Ripple's "key roles is

[7] Larsen also donated one billion of his own XRP to an entity whose sales of approximately 639 million XRP into the public he coordinated to further Ripple's goal of achieving widespread trading of XRP. ¶¶ 136-40.

making sure that we distribute [XRP] as broadly in a way that adds as much utility and liquidity as we possibly can." ¶ 265. He stated that he thought "our incentives are very well aligned…that for Ripple Labs to do well we have to do a very good job in protecting the value of XRP and the value of the network, and that really is the guiding principle here in our distribution of XRP." *Id.*

In its 2014 Promotional Document, Ripple explained its "plans to retain 25% of all XRP issued to fund operations (and hopefully turn a profit)." ¶ 299. Larsen similarly explained, in an online interview dated April 14, 2014, that Ripple was "keeping 25% of…XRP…to cover the bills." ¶ 300. Larsen also explained that Ripple was "keeping 25% of those XRP, and using the rest of it to incent market makers, gateways, consumers to come onto the protocol." ¶ 168.

Larsen was also instrumental to the formation of an escrow (the "XRP Escrow") that Ripple created for its large XRP holdings in order to assuage investor concern that Ripple's sales could cause XRP's price to crash. ¶¶ 221, 223. Larsen helped create the XRP Escrow by developing and approving the idea, which Ripple promoted as beneficial to XRP investors. ¶¶ 224, 228.

2. Garlinghouse

Starting at least by 2016, Garlinghouse began to oversee, direct, and lead Ripple's efforts to make XRP available for purchasers to buy and sell on digital asset trading platforms incorporated in the U.S. and abroad. ¶ 154. Ripple and Garlinghouse engaged in these efforts because they believed that making XRP available on digital asset trading platforms was critical to all XRP holders' ability to sell XRP into the market at higher prices. ¶¶ 155, 160. Garlinghouse negotiated deals with several platforms to list XRP so that XRP could be easily bought and sold. ¶¶ 156-58.

As a result, in 2017 and 2018, Ripple entered into agreements with at least ten digital asset trading platforms—none of which were registered with the SEC in any capacity, and at least two of which have principal places of business in the U.S.—providing for "listing" and trading incentives with respect to XRP. ¶ 161. Garlinghouse viewed these types of efforts as critical components of

Ripple's efforts as to XRP. ¶ 166. In an internal March 29, 2018 email, he described Ripple providing incentives to platforms that trade XRP as an example of Ripple "do[ing] whatever we can to invest in the success of the XRP ecosystem[.]" *Id.*

While he was CEO (and as Larsen had before him), Garlinghouse had final decision-making authority over which trading venues to use for Market Sales and how much XRP to sell on a particular venue, which Ripple communicated to traders as an overall percentage of XRP's daily trading volume. ¶ 98. As CEO, Garlinghouse approved the timing and amounts of unregistered offers and sales of XRP, just as Larsen had. ¶¶ 75-76, 424-25. Garlinghouse's decisions included whether to adjust Ripple's XRP sales—sell more or less XRP—based on factors such as XRP's trading volume in the market, the market price of XRP, or Ripple's need for capital. ¶ 424.

Garlinghouse also played a significant role in negotiating and approving Ripple's Institutional Sales and other offers and sales of XRP to institutional investors, including while he was COO. ¶ 110. For example, in mid-2015, Garlinghouse negotiated an institutional investor's purchase of XRP in connection with the investor's potential formation of a "private investment fund" whose sole purpose would have been to speculate on XRP as an investment ("XRP Fund A"). ¶ 111. On July 10, 2015, Garlinghouse emailed that potential investor a document—which Ripple had created in 2014 and which Garlinghouse described to the potential investor as a "white paper"—entitled *"The Ripple Protocol: A Deep Dive for Financial Professionals"* (the "2014 Promotional Document"). *Id.* On August 3, 2015, Ripple, through XRP II, entered into a "Memorandum of Understanding" that Larsen signed on XRP II's behalf. *Id.* That agreement committed Ripple to selling XRP to that institutional investor for the purpose of having XRP Fund A own the purchased XRP. *Id.* Later that year, around November 2015, Garlinghouse, Larsen, and others received drafts of the potential offering documents for XRP Fund A and provided comments on these documents. *Id.* Similarly, in April 2016, Garlinghouse approved the sale of 115 million XRP to a different institutional investor that describes itself as a "full-service digital currency prime broker." ¶¶ 115-16. Two years later, on September 24, 2018, Ripple entered into an agreement, signed by Garlinghouse, with a Japanese institutional investor, which ultimately purchased over one billion XRP from Ripple. ¶¶ 120-23.

Finally, Garlinghouse engaged in extensive efforts to tout XRP with a consistent chorus of promotional statements on Twitter, on Ripple's website and YouTube channel, and in various press interviews. For example, in a May 16, 2017 article on Ripple's website, Garlinghouse reminded investors that, "[t]o build XRP liquidity, we have been mindful over the years about how we distribute XRP. Our goal in distributing XRP is to incentivize actions that build trust, utility and liquidity." ¶ 266. He concluded that, to incentivize financial institutions, payment providers, and banks to "use" XRP (though none had up to that point), Ripple "remain[ed] committed to increasing XRP liquidity." *Id.* Garlinghouse gave interviews and made public statements touting Ripple's efforts to develop and maintain a public market for XRP investors to resell XRP. ¶¶ 277-279. Garlinghouse publicly touted the formation of the XRP Escrow as proof that Ripple and XRP holders shared a common interest in the success of Ripple's efforts as to XRP and as one of Ripple's many efforts to manage the trading market for XRP. ¶ 228. Garlinghouse made numerous public statements describing his and Ripple's efforts to build value for XRP. ¶¶ 253-56, 260-62. He frequently and publicly encouraged investors to view their interests as aligned with Ripple's. ¶¶ 306-11. Similarly, Garlinghouse led investors to reasonably expect a profit from their investment in XRP from Defendants' efforts. ¶¶ 320, 325-26, 329, 330, 334, 336-38, 342-49, 356-57.

STANDARD OF REVIEW

To withstand a Rule 12(b)(6) motion to dismiss, "a plaintiff must plead sufficient factual allegations in the complaint that, accepted as true, 'state a claim to relief that is plausible on its face.'" *Walker*, 404 F. Supp. 3d at 823 (citing *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009)). "A plaintiff is not required to provide 'detailed factual allegations' in the complaint, but must assert 'more than labels and conclusions[ ] and a formulaic recitation of the elements of a cause of action.'" *Id.* (citing *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 555 (2007)). "The court must accept the allegations in the pleadings as true and draw all reasonable inferences in favor of the non-movant." *Id.* (citing *ATSI Commc'ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 98 (2d Cir. 2007)); ***see also*** *Herod's Stone Design v. Mediterranean Shipping Co. S.A.*, 434 F. Supp. 3d 142, 155 (S.D.N.Y. 2020) (same).

ARGUMENT

I. THE COMPLAINT ADEQUATELY ALLEGES THAT DEFENDANTS AIDED AND ABETTED RIPPLE'S VIOLATIONS OF SECURITIES ACT SECTION 5.

To properly plead its aiding-and-abetting claim, the SEC must allege (1) the existence of a securities law violation; (2) the aider and abettor's knowledge or reckless disregard of the primary violation; and (3) 'substantial assistance' by the aider and abettor "in the achievement of the primary violation." *SEC v. Apuzzo*, 689 F.3d 204, 211 & n.6 (2d Cir. 2012) (quoting *SEC v. DiBella*, 587 F.3d 553, 566 (2d Cir. 2009)); *see also* 15 U.S.C. § 77o(b). "[T]he SEC's scienter [pleading] burden is lessened significantly [when] the complaint is replete with allegations describing [one defendant]'s participation in almost every stage of the scheme." *SEC v. Wey*, 246 F. Supp. 3d 894, 928-29 (S.D.N.Y. 2017). The scienter requirement in aiding and abetting cases exists to avoid holding someone liable for the mistakes of third parties or for engaging only in ministerial tasks. *See, e.g.*, *Monsen v. Consol. Dressed Beef Co., Inc.*, 579 F.2d 793, 799 (3d Cir. 1978).

Defendants do not dispute that the Complaint alleges the existence of Ripple's violation of Securities Act Section 5 or that that violation involved unregistered offers and sales of "investment contracts." Garlinghouse also does not dispute that the SEC adequately pleads his substantial assistance, the third element of the aiding-and-abetting claim against him. Defendants contend that the Complaint does not adequately plead their knowing or reckless disregard of Ripple's violation, and Larsen contends that the Complaint does not adequately plead his substantial assistance of Ripple's violations. Both of these arguments are meritless.

A. The Complaint Adequately Pleads That Defendants Knew or Recklessly Disregarded Ripple's Section 5 Violation.

"Satisfaction of the [knowledge] requirement" in an aiding and abetting claim "will…depend on the theory of primary liability." *DiBella*, 587 F.3d at 566 (citation omitted). The primary violation at issue here is Ripple's violation of Securities Act Section 5. In this context, knowledge of the circumstances that constitute the primary violation satisfies the knowledge element of the SEC's claim. *See SEC v. Mattessich*, 407 F. Supp. 3d 264, 272 (S.D.N.Y. 2019) (citing *Apuzzo*, 689 F.3d at 211); *see also SEC v. Paulsen*, No. 18 Civ. 6718, 2020 WL 6263180, at *14 (S.D.N.Y. Oct. 23, 2020) (the SEC may show a "'defendant's general awareness of [his] overall role in the primary violator's illegal scheme'" (citations omitted)). Typically, "scienter…arguments are not appropriate for resolution on a motion to dismiss." *SEC v. Hurgin*, 484 F. Supp. 3d 98, 112-13 (S.D.N.Y. 2020); *see also Watson v. N.Y. Doe 1*, 439 F. Supp. 3d 152, 156 (S.D.N.Y. 2020) ("The [c]ourt's function on a motion to dismiss is 'not to weigh the evidence that might be presented at a trial but merely to determine whether the complaint itself is legally sufficient.'") (citation omitted).

1. The Complaint Pleads Sufficient Facts to Infer that Defendants Acted with a High Degree of Scienter.

Neither Defendant contends that the Complaint fails to sufficiently plead their knowledge of the facts that constitute Ripple's violation or their general awareness of their role in that scheme.

a. Larsen

As to Larsen, the Complaint pleads specific facts that Larsen approved and directed Ripple's unregistered offers and sales of XRP. These facts permit the inference that Larsen *knew* that Ripple was making offers and sales of XRP. *E.g.*, ¶¶ 75, 92, 95-96, 98, 100-102, 110, 113-116, 136, 140; *see supra* Statement of Facts § II.B.1(b). The Complaint also pleads that Larsen knew that Ripple's offers and sales of XRP were of "investment contracts," because he personally promoted XRP as an investment of money into a common enterprise with the reasonable expectation of profit from

Ripple's efforts. *E.g.*, ¶¶ 38, 42, 44-46, 73, 89, 90, 92, 98, 101-02, 112, 113, 171-179, 232, 242, 246, 265, 289, 293-94, 300, 397, 313; *see supra* Statement of Facts § III.A.3. The Complaint further pleads that Larsen was aware that such offers and sales could be wrongful under certain circumstances, [redacted]. *E.g.*, ¶¶ 52, 56, 399-401; *see also* Ex. B & C; *see supra* Statement of Facts §§ III.A.2, III.A.4. Finally, the Complaint pleads that Larsen was aware of his overall role in Ripple's illegal distribution, that his own financial interests were aligned with Ripple's interests, and that he took steps to further them. *E.g.*, ¶¶ 18, 46, 173, 179.

b. Garlinghouse

As for Garlinghouse, the Complaint alleges that he treated XRP like an investment and was incentivized to increase XRP's trading price and volume, ¶ 422, like a CEO treats compensation received in the form of company stock. That Garlinghouse treated and viewed XRP as an investment—and understood the nature of the asset—is also shown by his statements that he was "very long" the asset, ¶ 412, while making extensive sales to monetize his compensation. ¶ 87.

Indeed, the mere fact that Garlinghouse's (and Larsen's) financial interests were aligned with Ripple's suffices to show, at the pleading stage, that Garlinghouse acted with the requisite scienter for aiding and abetting a Section 5 violation. *SEC v. North Am. Research Dev. Corp.*, 424 F.2d 63, 81 (2d Cir. 1970) ("no financial stake or motivation is required to support a charge of Section 5 violation [including] with respect to those who assisted the principal wrongdoers out of friendship or other non-pecuniary motives"). As explained in *Barker v. Henderson, Franklin, Starnes & Holt*, a court looks to whether a defendant accused of aiding and abetting securities laws violations had a financial interest in the scheme to determine whether the violation was "in the interest of the defendants." 797 F.2d 490, 497 (7th Cir. 1986) (Easterbrook, J.).[8]

The cases Garlinghouse cites are not to the contrary. *See* Garlinghouse Br. at 16. Those cases stand for the unremarkable proposition that, in the fraud context, a desire to increase "stock price or improve[ ] corporate performance" is insufficient to plead scienter. *ECA and Local 134 IBEW Joint Pension Tr. of Chi. v. J.P. Morgan Chase Co.*, 553 F.3d 187, 201 (2d Cir. 2009); *see also Kalnit v. Eichler*, 264 F.3d 131, 139-40 (2d Cir. 2001). This case, by contrast, involves a "concrete and personal benefit" for Defendants, *Kalnit*, 264 F.3d at 139—the desire to create and maintain a market to make their *own personal sales* of XRP. *See also Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 325 (2007) (a "personal financial gain may weigh heavily in favor of a scienter inference"); *SEC v. Subaye, Inc.*, No. 13 Civ. 3114, 2014 WL 448414, at *8 (S.D.N.Y. Feb. 4, 2014) ("[P]leading 'motive' in the form of a concrete personal benefit derived from an alleged fraud is…one possible method of demonstrating scienter.") (citing *Novak v. Kasaks*, 216 F.3d 300, 307 (2d Cir. 2000)).

Moreover, the Complaint makes specific allegations from which one can reasonably infer Garlinghouse knew (1) that Ripple was making unregistered offers and sales of XRP, because he approved many such specific transactions, *e.g.*, ¶¶ 75-76, 98, 110-11, 115-16, 120-23, 154-55, 156-58, 160-62, 166, 424-26; *see supra* Statement of Facts § II.B.2; (2) that Ripple's offers and sales constituted offers and sales of "investment contracts," because he himself promoted XRP as such, *e.g.*, ¶¶ 98, 101, 104, 110-11, 118, 120, 199, 205, 207, 212, 219, 242, 253-56, 260-62, 266, 278-79, 293, 306-11, 329-30, 334, 336, 338, 342-49, 421; *see supra* Statement of Facts § III.B.1; (3) that such offers and sales could be improper under certain circumstances, because he was so warned by advisors,

[8] The requirement of "'conscious and specific' motivation to aid and abet the fraud will hopefully serve to deter nuisance suits against defendants who merely performed clerical duties without knowledge that they were furthering allegedly fraudulent transactions. It will also preserve causes of action against members of the financial community who knowingly participate on the fringes of fraudulent schemes for personal gain." *Martin v. Pepsi-Cola Bottling Co.*, 639 F. Supp. 931, 935 (D. Md. 1986) (citing *IIT v. Cornfeld*, 619 F.2d 909, 927 (2d Cir.1980)).

acknowledged that fact publicly and privately, and knew that the status of XRP under the securities laws was of keen interest to the digital asset platforms he tried to persuade to list XRP, *e.g.*, ¶¶ 405-20; *supra* Statement of Facts § III.B.2; and (4) understood his role in Ripple's violations because he orchestrated them and they were aligned with his own interests, *e.g.*, ¶¶ 181-83, 190-92, 422 (Garlinghouse had incentive to obtain more favorable prices for his own sales of XRP).

2. Defendants' Contrary Arguments Misapply the Law.

Defendant do not attempt to grapple with the obvious implications of the SEC's allegations that they knew (or at least recklessly disregarded) exactly what they were doing and the potential legal consequences of those actions. Instead, Defendants make two interrelated but ultimately meritless arguments. First, they seek to convince the Court that the SEC must establish that they *actually knew* the instruments at issue were *actually securities* under the law. No such legal requirement exists. Second, they try to persuade the Court to weigh evidence, make factual findings, and draw inferences of their supposed good faith in their favor. This argument is highly improper on a motion to dismiss and should be rejected. *Hurgin*, 484 F. Supp. 3d at 112-13.

a. There is No Legal Basis for Defendants' Heightened Scienter Requirement, but the Complaint Alleges Facts to Meet It.

The crux of Defendants' argument is their erroneous contention that the SEC must allege that Defendants knew that XRP was in fact a security *as a matter of law*. *E.g.*, Garlinghouse Br. at 4, 16; Larsen Br. at 1, 16.

However, the SEC is not required to allege that Defendants knew *the legal consequences* of their actions. As the D.C. Circuit explained long ago:

> Knowledge means awareness of the underlying facts, not the labels that the law places on those facts. Except in very rare instances, no area of the law not even the criminal law demands that a defendant have thought his actions were illegal. A knowledge of what one is doing and the consequences of those actions suffices.

SEC v. Falstaff Brewing Corp., 629 F.2d 62, 77 (D.C. Cir. 1980). The Second Circuit also has rejected the argument that, in a criminal prosecution, the defendants had to have known that the "units" they were selling possessed the characteristics that made them securities. *See United States v. Leonard*, 529 F.3d 83, 91-92 (2d Cir. 2008); *see also United States v. Brown*, 578 F.2d 1280, 1284 (9th Cir. 1978) ("The government need only prove that the object sold or offered is, in fact, a security; it need not be proved that the defendant had specific knowledge that the object sold or offered was a security.").

Many of the cases Defendants cite in support of their proffered pleading standard actually reject it. In *SEC v. Mattessich*, for example, defendants argued that the SEC had not sufficiently pled the scienter element of an aiding-and-abetting claim where the SEC had not pled that defendants had "knowledge of the specific SEC Rule" the primary violator violated. 407 F. Supp. 3d at 272 (cited in Larsen Br. at 12). Judge Failla rejected this argument, relying on *Falstaff Brewing* and on the fact that the rule at issue—like Securities Act Section 5—had no scienter requirement. *Id.* Instead, she held that to "state a claim for aiding and abetting, the SEC need not allege that Defendants knew the specific…rule that they helped violate." *Id.* Similarly, in *SEC v. Espuelas* (cited in Garlinghouse Br. at 12; Larsen Br. at 12), Judge Engelmayer noted that he "need not" resolve the issue of whether a defendant had sufficient knowledge to appreciate that his practices were improper, because there was no evidence that the defendants "knew of the facts" that underlay the primary violation. 905 F. Supp. 2d 507, 518 (S.D.N.Y.2012); *see also id.* at 525 (dismissing aiding and abetting claims due to lack of evidence that the defendant "knew of the features of the…transactions that made [them] improper"). Indeed, when other defendants in the same case later argued that they were entitled to summary judgment on the SEC's aiding-and-abetting claim because there was no evidence that they knew how to apply the specific accounting rule at issue in the case, Judge Engelmayer *rejected* that contention, noting that a "defendant's general awareness of its overall role in the primary violator's illegal scheme is sufficient knowledge for aiding and abetting liability." *SEC v. Espuelas*, 908 F. Supp. 2d 402, 410 (S.D.N.Y. 2012) (citation omitted).[9]

Here, of course, the SEC *does* allege facts that, if proven, would permit a fact-finder to conclude that Defendants knew XRP was being offered and sold as part of investment contracts. Larsen *explicitly acknowledged* he was running the risk that he would be considered the issuer of securities by the SEC in exchange for significant financial compensation. ¶¶ 56-57; Ex. E. Moreover, as described above in more detail in Statement of Facts § III.A.3, the Complaint alleges Larsen's (1) awareness of Securities Act Section 5 liability and the *Howey* test given his involvement with the Prosper Order, ¶ 18, Ex. A; (2) [redacted], ¶¶ 52, 56; [redacted]); ¶¶ 73, 89, 92, 98, 101-02, 112, 113, 171-179, 232, 242, 246, 289, 397 (Larsen's [redacted]); and (3) receipt of additional warnings that XRP was a security in the face of the FinCEN settlement's acknowledgement that a "virtual" currency is not a "real" currency. ¶¶ 399-404.

Similarly, the Complaint alleges that Garlinghouse repeatedly received warnings about risks that XRP could be a security or had "securities like" characteristics, *e.g.*, ¶¶ 407, 408, 411; that he knew that XRP's status under the securities laws was a critical question, *e.g.*, ¶¶ 414-16, 419; that he openly acknowledged the specific factors that could make XRP a security under *Howey*, *e.g.*, ¶¶ 406, 409, 412, 413, 421, ultimately leading him to conclude that he could "not guarantee" that XRP was not a security, ¶ 420. Garlinghouse also was concerned with "verbiage" in communications that

[9] Defendants' citation to *SEC v. Paulsen* fares no better. *See* Larsen Br. at 12, 16; Garlinghouse Br. at 12, 19. There, Judge Gardephe cited the same standard the SEC sets forth here: that "[t]o establish knowledge, the SEC must show a 'defendant's general awareness of [his] overall role in the primary violator's illegal scheme.'" No. 18 Civ. 6718, 2020 WL 1911208, at *5 (S.D.N.Y. Apr. 18, 2020). In denying summary judgment to the SEC, Judge Gardephe *did not*, as Defendants suggest, require the SEC to prove that the defendant knew the legal consequences of his acts. He simply held—as this Court should hold—that issues that implicate "knowledge and intent, and the inferences that should be drawn from the evidence" are for fact-finders to resolve. *Id.*

could make "XRP sound[ ] like a security," ¶ 408, while using that verbiage himself publicly, such as by stating he was "very long XRP," ¶ 411, or touting "significant improvements in…[the] price of XRP" which was up "over 5,000 percent from the beginning of 2017!." ¶ 343. Despite being asked by multiple U.S. trading platforms about the legal status of XRP under the federal securities laws, ¶ 415, Garlinghouse never sought any guidance on this question from the SEC, ¶ 59.

All of these allegations more than suffice to plead Larsen's and Garlinghouse's knowledge or recklessness and, if proven, will allow a fact-finder to conclude that Defendants knew or were reckless in not knowing that Ripple's XRP offers and sales could constitute offers and sales of securities. *See, e.g.*, *Novak v. Kasaks*, 216 F.3d 300, 308 (2d Cir. 2000) ("[A]n egregious refusal to see the obvious or investigate the doubtful, may in some cases give rise to an inference of recklessness."); *Global-Tech Appliances, Inc. v. SEB S.A.*, 563 U.S. 754, 766 (2011) (defendants in civil cases who consciously avoid knowledge are "just as culpable as those who have actual knowledge"); *United States v. Svoboda*, 347 F.3d 471, 480 (2d Cir. 2003).

b. The Court Should Not Weigh Evidence or Make Factual Findings on a Motion to Dismiss.

Defendants' remaining arguments boil down to a plea that the Court interpret the Complaint's well-pleaded factual allegations in their favor and that it draw "conclusion[s]" that defendants view as "entirely consistent" with these facts. *E.g.*, Garlinghouse Br. at 15. This is highly improper on a motion to dismiss. *E.g.*, *Hurgin*, 484 F. Supp. 3d at 112-13.

Both Garlinghouse (Garlinghouse Br. at 15) and Larsen (Larsen Br. at 14-15) ask the Court to decide that they must have reasonably believed XRP was not a "security," based on Ripple's 2015 settlement agreements with FinCEN and the Department of Justice, in which they labeled XRP a "virtual currency." Defendants' argument is perplexing given their insistence that they did not know the specific requirements of the federal securities laws. As Defendants point out, the definition of "security" under the Exchange Act of 1934 excludes "currency." 15 U.S.C. § 78c(a)(10). To accept their arguments, the Court must conclude that Defendants knew enough about the securities laws to know that the definition of "investment contract" excludes "currency," but did not understand the legal factors that make something a security or that something may be sold as a security even if it is a "virtual currency." Defendants cite no support in the complaint or the documents it references for this absurd argument—that they had a partial understanding of what constitutes a security—and their briefs otherwise disclaim virtually any knowledge of the securities laws.

Moreover, to reach Defendants' proffered interpretation of the facts, the Court would have to ignore a fact of which it properly may take judicial notice: that the DOJ and FinCEN settlements with Ripple in 2015 specifically referenced certain guidance about "virtual currency" that FinCEN had issued in 2013. *See* D.E. 114-3 at 7-8; D.E. 114-4 at 7-8. In that guidance, FinCEN had noticed that "in contrast to real currency," "virtual currency" (as it called XRP in the settlements) "does not have all the attributes of real currency. In particular, virtual currency does not have legal tender status in any jurisdiction." Ex. D (*Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies* (Mar. 18, 2013) ("FinCEN Guidance")); *see also* ¶ 382 (XRP is not legal tender in any jurisdiction). That guidance put Defendants on actual notice that, just because DOJ and FinCEN had labeled XRP a "virtual currency" in their settlements, did not mean that XRP was a "currency" excluded from the definition of a "security" under the Securities Act.

Defendants' citation to *Safeco Ins. Co. of Am. v. Burr*, 551 U.S. 47, 70 n.20 (2007), (Garlinghouse Br. at 17, Larsen Br. at 14) is meritless. There, the Supreme Court noted that it was *not* confronted with "a case in which the business subject to the Act had the benefit of guidance from the courts of appeals or the [regulatory agency] that might have warned it away from the view it took." *Burr*, 551 U.S. at 70. Here, by contrast, there is an "abundance of caselaw interpreting and applying *Howey* at all levels of the judiciary, as well as related guidance issued by the SEC as to the scope of its regulatory authority and enforcement power," *United States v. Zaslavskiy*, No. 17 Cr. 647, 2018 WL 4346339, at *9 (E.D.N.Y. Sept. 11, 2018), [redacted]. For *Safeco* even to be relevant, the Court would first have to reach the untenable legal conclusion that the Securities Act *did not* have "the benefit of guidance from the courts of appeals" or the SEC. At a minimum, that is a question at the heart of the parties' dispute on the merits and cannot be reached on a motion to dismiss that does not present the issue.[10]

The remainder of Garlinghouse's arguments similarly seek to engage the Court in weighing evidence and drawing inferences in his favor. For example, Garlinghouse asks the Court to draw conclusions about his scienter based on the fact that Platform A listed XRP, which Garlinghouse claims "demonstrat[es] that Platform A itself ultimately considered and rejected the risk that XRP was a security." Garlinghouse Br. at 14. This is not a case against Platform A, nor is there a "reliance on trading platforms" legal defense to scienter. Whatever conclusions Garlinghouse may have fairly reached about the legality of his own conduct, given that he had been instrumental in Platform A's decision to list XRP, ¶ 414, is to be resolved on the merits, not on a motion to dismiss. Although Garlinghouse cites to cases like *Slayton v. American Express Co.* to argue that he acted in "good-faith" to "inform" himself about the legality of his conduct, Garlinghouse does not contend that he actually took steps to inform himself of these risks by consulting an attorney (and disclaims

[10] Another example also illustrates this problem. Larsen seeks to brush away the Complaint's allegation that he knew that investors were purchasing XRP for speculation. Larsen Br. at 19. In Larsen's mind, this is not sufficient evidence of his knowledge or reckless disregard for the legal consequences of his actions because, *on the merits*, the fact that someone was purchasing XRP "for speculation…is not sufficient to render XRP a security." *Id.* But that is not the SEC's argument. XRP was an investment contract not *simply* because it was purchased for speculation, but because it was offered and sold as an investment of money into a common enterprise with a reasonable expectation of profits from the efforts of others. That Larsen was specifically aware of *one* of the factors that render Ripple's conduct illegal shows that the SEC has properly pled his scienter at this stage. Larsen's argument invites the Court to make a ruling *on the merits* about whether that factor renders XRP a security. The Court should decline this invitation.

any knowledge of the Legal Memos), a fact which distinguishes his conduct from the defendant in *Slayton*. 604 F.3d 758, 777 (2d Cir. 2010) (cited in Garlinghouse Br. at 14).[11]

Garlinghouse similarly asks the Court to make factual findings, arguing that his statements acknowledging that, if an asset being sold had no real utility, it was likely a security should be weighed against his statements that he believed XRP had utility. *E.g.*, Garlinghouse Br. at 14-15. These arguments again require reaching factual conclusions: they ignore that Garlinghouse was specifically aware that XRP had no "use" when he made public statements to the contrary. ¶ 413. And Garlinghouse's convenient after-the-fact reliance on his self-professed belief in "regulatory uncertainty," Garlinghouse Br. at 1, 7, 14, must also be weighed—by a fact-finder, not on a motion to dismiss—against his own more candid admission that "people in the crypto space talking about 'regulatory uncertainty'…more often than not means 'I disagree with the regulatory certainty so I'm going to call it regulatory uncertainty.'" ¶ 413. Put another way, Garlinghouse made clear that people often said there was "regulatory uncertainty" about whether a digital asset was being sold as a security when really they knew it was being sold as a security but did not like that conclusion.[12]

B. The Complaint Adequately Alleges That Larsen Substantially Assisted Ripple's Violations.

The SEC must only allege that Larsen participated in Ripple's violation "as in something that he wished to bring about, and that he sought by his action to make it succeed." *SEC v. Rio Tinto plc*, No. 17 Civ. 7994, 2019 WL 1244933, at *18 (S.D.N.Y. Mar. 18, 2019) (citation omitted).

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[11] Defendants received extensive legal advice about the potential legal consequences of their conduct, but Ripple has refused to disclose that advice on privilege grounds, despite its fair-notice affirmative defense that puts its understanding of the law in dispute. *See generally* D.E. 165 (letter to Magistrate Judge Netburn seeking production of documents showing certain legal advice). Should Defendants continue to insist that they acted in good faith while Ripple does not produce these documents, Defendants will not be able to advance this defense as a matter of law. *See, e.g.*, *United States v. Wells Fargo Bank, N.A.*, 132 F. Supp. 3d 558, 566-67 (S.D.N.Y. 2015) (granting protective order against individual defendant's assertion of good faith where corporation refused to waive privilege as to relevant documents).

[12] Both Defendants also point out that the SEC does not allege that they lied to people. Larsen Br. at 16; Garlinghouse Br. at 16. This is beside the point—there is no legal requirement that the SEC prove *deceptive* conduct to properly plead that a defendant aided and abetted a strict liability offense. And the Complaint alleges that at least Garlinghouse misled the market by touting that he was "very long" XRP while he was actually selling large quantities of XRP.

Here, the SEC pleads numerous facts that show that Larsen actively participated in Ripple's unregistered public distribution of securities as something he wished to bring about and sought to make succeed. The Complaint pleads that Larsen's and Ripple's financial incentives with respect to XRP were closely aligned, such that Larsen worked "in coordination with Ripple to develop and maintain a liquid market for XRP through which [Larsen and Ripple] could monetize their [XRP] holdings." ¶ 173. Larsen did so by using the same Market Maker as Ripple to make similar XRP sales on similar platforms, ¶¶ 174-77, and by making his own sales to the tune of over $450 million over the course of many years, ¶¶ 175-76; *see also* ¶¶ 85-86. Larsen did so because, as he explained to an XRP investor in a June 30, 2019 email, he shared in Ripple's view that it is "better to have widely held assets," which his own XRP sales fostered. ¶ 179.

Larsen has no response to these allegations other than to claim that the Complaint fails to "plead sales with specificity," Larsen Br. at 20, but he can identify no legal requirement that the SEC list each and every sale at the pleadings stage. *See, e.g.*, *Armstrong v. McAlpin*, 699 F.2d 79, 91 (2d Cir. 1983) (allegation that broker was the principal broker during the ten-year period of violative trades sufficient to state an aiding-and-abetting claim at the pleadings stage). Larsen also cites *Wey*, 246 F. Supp. 3d at 930, for the proposition that a complaint properly pleads substantial assistance where the "defendant distributed shares," Larsen Br. at 21, which is exactly what Larsen did here.

In any event, the Complaint pleads other affirmative acts by Larsen that furthered Ripple's unregistered offers and sales of XRP—none of which depends upon Larsen's particular title at the time, as Larsen contends, *see* Larsen Br. at 19-20. They include: (1) initially and subsequently approving and coordinating Ripple's Market Sales of XRP, ¶¶ 92, 98, 100, 199, 205, 207, as Ripple represented to others Larsen was responsible for, ¶ 72; (2) negotiating and entering into particular XRP Institutional Sales on behalf of Ripple, ¶¶ 113-16; (3) participating in Ripple's efforts to promote XRP on various digital asset trading platforms, ¶ 168; and (4) creating the XRP Escrow to assuage XRP investors' concerns about the price of XRP. ¶¶ 223-24. Although Larsen erroneously contends that the SEC "fails to allege any specific statements" by himself promoting XRP, Larsen Br. at 20, the Complaint identifies a specific interview in which Larsen explained Ripple's "key roles" in distributing XRP as broadly as possible to add liquidity to the market and setting forth his view that Ripple will "do a very good job in protecting the value of XRP." ¶ 265.

Any one of these affirmative acts—alone or in tandem with others—sufficiently alleges substantial assistance, regardless of Larsen's title. "[A]t the motion to dismiss stage, the SEC must only allege" Larsen engaged in conduct that "contributed to the larger scheme." *SEC v. Sugarman*, No. 19 Civ. 5998, 2020 WL 5819848, at *9 (S.D.N.Y. Sept. 30, 2020) (citing *SEC v. Sason*, 433 F. Supp. 3d 496, 509 (S.D.N.Y. 2020)). The SEC "is not required to allege that [Larsen] 'participated in each and every aspect'" of the violation at issue. *Id.* (citing *Wey*, 246 F. Supp. 3d at 916); *see also In re Refco Inc. Secs. Litig.*, No. 08 Civ. 3065, 2012 WL 996910, at *7 (S.D.N.Y. Jan. 17, 2012) ("[S]ubstantial assistance with one part of the [violation] is sufficient to withstand a motion to dismiss [an] aiding and abetting claim."); *Armstrong*, 699 F.2d at 91-92 (allegations covering a ten-year period sufficient to survive a motion to dismiss, and a "decision as to [defendant's] liability for aiding and abetting the alleged [violations] must await further development of the facts").[13]

II. THE COMPLAINT ADEQUATELY ALLEGES THAT DEFENDANTS ENGAGED IN DOMESTIC OFFERS AND SALES OF SECURITIES.

Securities Act Section 5 was designed in part to empower the SEC to stop noncompliant securities offerings before transactions are complete. *E.g.*, *SEC v. Telegram Grp., Inc.*, 448 F. Supp. 3d 352 (S.D.N.Y. 2020) (preliminarily enjoining $1.7 billion offering by foreign issuer that included U.S. investors before issuer could distribute the digital token). Relying on a Supreme Court case where Australian purchasers who bought securities on an Australian exchange sued an Australian bank

[13] Larsen's argument that the level of his substantial assistance changed from one year to the next is only relevant at the relief stage in this proceeding. *E.g.*, *Cavanagh*, 155 F.3d at 135.

under a different statute, Defendants contend that U.S. citizens located in the U.S. and selling securities—at least in part—to U.S. investors do not have to comply with the registration provisions of the U.S. securities laws as long as they use a digital trading platform that clears transactions in a foreign country. The Court should reject this argument out of hand based on the plain text of Section 5, which explicitly encompasses the process of offering securities.

To adequately plead a Section 5 claim against a defendant, the SEC must allege: (1) that no registration statement was filed or in effect as to the offer or sale of securities, and (2) that the defendant directly or indirectly sold or offered to sell the securities (3) through interstate commerce. *SEC v. Cavanagh*, 445 F.3d 105, 111 n.13 (2d Cir. 2006). Here, without any registration statement filed or in effect—and acting on behalf of a U.S. issuer—Defendants engaged in extensive U.S.-based promotional efforts to create a worldwide market for XRP, and from the U.S. directed the sale of those securities into that global market, including into the U.S. Every part of Defendants' public distribution of XRP violated Securities Act Section 5.

Against this background, the SEC and Defendants agree that Securities Act Section 5 covers "domestic" activities. The parties differ as to what constitutes domestic "offer[s]" and/or "sale[s]" of securities under Section 5. The proper criteria to make that determination are in Regulation S under the Securities Act, 17 C.F.R. § 230.901 *et seq.*, which the SEC promulgated to define precisely that—what constitutes domestic and what constitutes foreign offerings for purposes of Section 5. Defendants' offers and sales indisputably did not qualify as "foreign" under Regulation S. Defendants, however, insist that the Court import the Supreme Court's transactional test developed in *Morrison* to determine whether a "purchase or sale" for purposes of *Exchange Act Section 10(b)* is domestic. *Morrison* addressed a statute that did not encompass "offer[s]" of securities in its text. Securities Act Section 5, by contrast, is the principal federal statute regulating an "offer to sell or offer to buy" securities, 15 U.S.C. § 77e(a), (c), and Defendants' request that the same test apply to both provisions would erase the fundamental distinction between them.

Indeed, *Morrison* itself forecloses Defendants' argument. Under *Morrison* and cases following it, the Court must determine the "focus" of the statutory provisions at issue to resolve whether the case involves a permissible domestic application of the law. 561 U.S. at 267. Extensive case law establishes the breadth of the terms "offer" (a word not in Exchange Act Section 10(b)) and/or "sale" in Section 5. And *Morrison* itself explicitly recognized that Regulation S properly cabins the territorial reach of Section 5 by defining what constitutes domestic and what constitutes foreign conduct for purposes of that law. Moreover, looking at the provisions that work in tandem with Securities Act Section 5, as *Morrison* requires, shows that their focus is on the entire offering process. These principles make clear that a litany of acts Defendants committed in the U.S. fall within the ambit of "offer" and/or "sale," requiring registration to provide essential disclosures to the U.S. investors to whom these U.S. Defendants pitched and sold their U.S. securities.

Defendants cannot genuinely quarrel with these principles. They argue without support that the Court should skip past *Morrison*'s directive to determine the focus of the statute at issue—here Securities Act Section 5—and ignore the breadth of the "offers" and "sales" that are Section 5's focus. They then try to cram the square peg of *Morrison's* transactional test for Exchange Act Section 10(b) into Section 5's round hole. But, even if the Court were to apply a transactional Exchange Act Section 10(b) test to Securities Act Section 5 claims (which it should not), the Complaint adequately pleads that Defendants' conduct meets that test. Defendants' motion to dismiss the Section 5 claims against them on extraterritoriality grounds should be denied.

A. The Focus of the Securities Act's Registration Requirements Determines If a Permissible, Domestic Application of the Statute Is at Issue.

Morrison establishes a "two-step framework for analyzing extraterritoriality issues." *RJR Nabisco, Inc. v. European Community*, 136 S. Ct. 2090, 2101 (2016). First, a court should ask if the relevant statute applies extraterritorially. *Id.* Second, the court should determine "whether the case involves a domestic application of the statute…by looking at the statute's *focus*." *Id.* (emphasis added). "If the conduct relevant to the statute's focus occurred in the United States, then the case involves a permissible domestic application even if other conduct occurred abroad." *WesternGeco LLC v. ION Geophysical Corp.*, 138 S. Ct. 2129, 2137 (2018) (quoting *RJR Nabisco*, 136 S. Ct. at 2101).

"The focus of a statute is 'the objec[t] of [its] solicitude,' which can include the conduct it 'seeks to regulate,' as well as the parties and interests it 'seeks to protec[t]' or vindicate." *Id.* (citing *Morrison*, 561 U.S. at 267) (internal quotation marks omitted, alterations in original). Importantly, "[w]hen determining the focus of a statute, we do not analyze the provisions at issue in a vacuum." *Id.* (citing *Morrison*, 561 U.S. at 267). Instead, "[i]f the statutory provision at issue works in tandem with other provisions, it must be assessed in concert with those other provisions. Otherwise, it would be impossible to accurately determine whether the application of the statute in the case is a 'domestic application.'" *Id.* (quoting *RJR Nabisco*, 136 S. Ct. at 2101).

Here, as to the first step, the SEC does not contend that Section 5 applies extraterritorially. The question is the second step of the inquiry: whether, looking to the "focus" of Securities Act Section 5, by assessing the statute with the other provisions that work in tandem with it as *Morrison* requires, this case involves a domestic application. As set forth below, Section 5's focus extends beyond the discrete moment when title to a security passes, or even when parties commit themselves to a purchase or sale. Rather, Section 5 is focused on the entire process by which securities emanate from issuers and their affiliates to come to rest in the hands of the investing public.

B. Securities Act Section 5 Focuses Broadly on Every Aspect of a Public Offering, Not Just Particular Sales.

The Securities Act is "chiefly concerned [with]…initial distributions of newly issued stock from corporate issuers." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 752 (1975). That is the proper "focus" of Securities Act Section 5, whose "primary innovation…was the creation of federal duties—for the most part, registration and disclosure obligations—in connection with public offerings." *Gustafson v. Alloyd Co., Inc.*, 513 U.S. 561, 575 (1995). Section 5 prohibits using interstate commerce to "sell [a] security," to "carry…[a] security for the purpose of sale or for delivery after sale," or "to offer to sell or offer to buy" a security, unless Section 5's registration requirements are met or an exemption applies. 15 U.S.C. § 77e(a)(1)-(2), (c). These provisions contemplate that the offer or sale of securities to the public must come with the "full and fair disclosure" afforded by registration with the SEC and delivery of a statutory prospectus containing detailed information about the issuer and the securities, necessary to enable purchasers to make an informed investment decision. *See SEC v. Cavanagh*, 1 F. Supp. 2d 337, 360 (S.D.N.Y. 1997), *aff'd*, 155 F.3d 129 (2d Cir. 1997). "The registration statement is designed to assure public access to material facts bearing on the value of publicly traded securities and is central to the Act's comprehensive scheme for protecting public investors." *SEC v. Aaron*, 605 F.2d 612, 618 (2d Cir. 1979) (citing *SEC v. Ralston Purina Co.*, 346 U.S. 119, 124 (1953)), *vacated on other grounds*, 446 U.S. 680 (1980).

Section 5, by its terms, is broad: it prohibits any conduct involving the unregistered offers or sales. Through provisions that provide for exemptions from this requirement, like Securities Act Section 4(a)(1), however, Congress distinguished between (1) transactions that occur during the process by which securities are distributed to the public from the issuer of the securities, which require registration, and (2) subsequent trading in the market by investors, which generally does not. L. Loss & J. Seligman, 2 Securities Regulation 627 (3d ed. 1989) (the § 4(a)(1) exemption is meant to distinguish "between distribution of securities and trading in securities") (quoting H.R. Rep. No. 85, 73d Cong., 1st Sess. 15 (1933)); *see also SEC v. Chinese Consolidated Benevolent Ass'n*, 120 F.2d 738, 740 (2d Cir. 1941) (Section 4(a)(1) "does not in terms or by fair implication protect those who are engaged in steps necessary to the distribution of security issues"); *SEC v. Holschuh*, 694 F.2d 130, 137-38 (7th Cir. 1982) (the Securities Act "was created to exempt routine trading transactions with respect to securities already issued and not to exempt distributions by issuers or acts of others who engage in steps necessary to such distributions"). Thus, transactions by issuers or others engaged in a distribution are not exempt from Section 5 registration requirements. *See* 15 U.S.C. § 77d(a)(1)-(2).

Meanwhile, Securities Act Section 2 defines "offer" broadly to include "every attempt or offer to dispose of, or solicitation of an offer to buy," a security; "sale" or "sell" to include "every… disposition of a security," *id.* § 77b(a)(3); "issuer" to include "every person who issues or proposes to issue any security," *id.* § 77b(a)(4); and "underwriter" to include "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security." *Id.* § 77b(a)(11). Accordingly, the "focus" of the Securities Act Section 5 requirement is a public offering, which is the *entire* process of distributing securities from an issuer to the public.

1. The Term "Offer" Goes Beyond its Common Law, Contractual Concept.

The Supreme Court has explained that "offer" and "sale" are "statutory terms[ ] which Congress expressly intended to define broadly…[and] are expansive enough to encompass the entire selling process." *United States v. Naftalin*, 441 U.S. 768, 773 (1979). Thus, "[i]t is not essential under the terms of the [Securities] Act that full title pass to a transferee for the transaction to be an 'offer' or a 'sale'." *Rubin v. United States*, 449 U.S. 424, 430 (1981). "[T]ransactions other than traditional sales of securities are within the scope of [Securities Act] § 2(3) and passage of title is not important." *Pinter v. Dahl*, 486 U.S. 622, 643 (1988) (quoting *Naftalin* and *Rubin*).

As a result, the definition of "offer" in Securities Act Section 2(a)(3) "extends beyond the common law contract concept of an offer." *Cavanagh*, 155 F.3d at 135; *see also Diskin v. Lomasney & Co.*, 452 F.2d 871, 875 (2d Cir. 1971). An offer occurs "[w]hen it is announced that securities will be sold at some date in the future and, in addition, an attractive description of these securities and of the issuer is furnished." *Chris-Craft Indus. v. Bangor Punta Corp.*, 426 F.2d 569, 574 (2d Cir. 1970). "What is dispositive…is whether defendants' conduct conditioned the public mind." *SEC v.*

Blockvest, LLC, No. 18 Civ. 2287, 2019 WL 625163, at *8 (S.D. Cal. Feb. 14, 2019) (enjoining future conduct in connection with public distribution of digital asset securities) (citation omitted); *Guidelines for the Release of Information by Issuers Whose Securities are in Registration*, Rel. 33-5180, 1971 WL 120474, at *1 (S.E.C. Aug. 1971) ("[T]he publication of information and statements, and publicity efforts…which have the effect of…arousing public interest in the issuer or in its securities constitutes an offer in violation of the Act.").

A statutory "offer" or "sale" can occur under a variety of circumstances including: (a) the contents of "website[s]" and "social media posts" concerning the asset, *Blockvest*, 2019 WL 625163, at *9; (b) statements to the public and to the press, *e.g.*, *Chris-Craft*, 426 F.2d at 574; *SEC v. Arvida Corp.*, 169 F. Supp. 211, 215 (S.D.N.Y. 1958); (c) written advertisements, *e.g.*, *Chinese Consolidated*, 120 F.2d at 740; and (d) transmittal of "an order to a broker to sell securities." *Naftalin*, 441 U.S. at 773; *see also Glen-Arden Commodities, Inc. v. Costantino*, 493 F.2d 1027, 1029, 1034 (2d Cir. 1974) ("[T]he test whether a contract constitutes an investment contract within the Securities Act is 'what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect.'") (quoting *SEC v. C.M. Joiner Leasing Co.*, 320 U.S. 344, 352-353 (1943)); *SEC v. Kik Interactive, Inc.*, 492 F. Supp. 3d 169, 178-79 (S.D.N.Y. 2020) ("courts regularly consider representations and behavior outside the contract," discussing *Joiner*).

Finally, in determining what acts constitute an "offer" covered by Securities Act Section 5, courts often look to SEC regulations for guidance. *E.g.*, *Chris-Craft*, 426 F.2d at 574-75 (defendant's failure to follow Securities Act Rule 135, which lists the type of statements that may be publicly made without constituting an "offer," meant the defendant had violated Section 5 and that adding an exemption not provided for in the rule "would…thwart other policies of the securities laws").

2. Section 5 and Section 4 Together Make Clear that the Registration Requirement's Focus Is All Aspects of Public Offerings.

Consistent with the principles above, the Second Circuit has at least twice held that a distribution of securities from an issuer into the hands of U.S. investors violated Section 5 even when the actual title to the securities passed abroad. First, in *Chinese Consolidated*, the court held that a defendant who had aided a foreign issuer in distributing securities to U.S. investors could be held liable for violating Section 5. 120 F.2d at 740-41. As the court held, "where there was systematic continuous solicitation, followed by collection and remission of funds to purchase the securities, and ultimate distribution of the bonds in the United States through defendant's aid[,] [the] results should [not] be determined by the mere passage of title to the securities in China." *Id.* at 741.

Likewise, in *SEC v. North American Research*, the Second Circuit affirmed a finding of Section 5 liability against individuals who had aided and abetted unregistered offers and sales of stock whose title first passed in Canada "with a view ***to the distribution*** [of the securities]…in the United States." 424 F.2d at 68 (emphasis added). The court again explicitly held that, for purposes of Section 5, "[i]t matters not that none of the shares [the defendant] owned was sold in the United States," *id.*, and explained that "the Securities Act of 1933 established a series of specific enactments and definitions…as to protect the investing public from the detrimental effect of the dissemination and distribution of unregistered securities," and that it is therefore important to "view the statutes not individually but as interdependent components of an integrated regulatory plan." *Id.* at 71, 82.

In each decision, the Second Circuit also reaffirmed the broad application of Section 5, explaining that the "primary purpose of the [Securities] Act" is "the protection of those who do not know market conditions from the overreachings of those who do," *North Am. Res. Dev. Corp.*, 424 F.2d at 81, and to "protect the public by requiring that it be furnished with adequate information upon which to make investments." *Chinese Consolidated*, 120 F.2d at 741.

Accordingly, the registration provisions' focus is "'the entire process by which in the course of a public offering the block of securities is dispersed and ultimately comes to rest in the hands of the investing public.'" *SEC v. Kern*, 425 F.3d 143, 153 (2d Cir. 2005) (quoting *R.A. Holman & Co., Inv. v. SEC*, 366 F.2d 446, 449 (2d Cir. 1966)); *see also Geiger v. SEC*, 363 F.3d 481, 487 (D.C. Cir. 2004) (holding that Section 5 covers "a public offering," defined as "the entire process…through which a block of securities is dispersed and ultimately comes to rest in the hand of the investing public" (quotation marks omitted)).[14] And these provisions must be given a "broad and liberal interpretation." *North Am. Res. Dev. Corp.*, 424 F.2d at 71.

C. *Morrison* Explicitly Recognized that Regulation S Defines What Constitutes a "Domestic" Public Offering under Securities Act Section 5.

In *SEC v. National Securities, Inc.*, the Supreme Court recognized the SEC's authority to define the terms used in the Securities Act. 393 U.S. 453, 465 (1969). The SEC thus promulgated Regulation S "to clarify the extraterritorial application of the registration requirements of the Securities Act." *Offshore Offers and Sales*, 55 F.R. 18306-01, at 18306 (S.E.C. May 2, 1990).

Morrison explicitly recognized that "the [SEC] has interpreted" the territorial reach of Section 5 with Regulation S. 561 U.S. at 268-69 (quoting 17 C.F.R. § 230.901). In support of its conclusion that Exchange Act Section 10(b) covered transactions in securities on national securities exchanges or "domestic transactions in other securities," the Court noted that the Securities Act is also focused on domestic conduct and pointed out that Regulation S properly defines the scope of what constitutes "domestic" and "foreign." *Id.* Thus, while the Court in *Morrison* developed a test for domesticity under Exchange Act Section 10(b), the Court recognized that the SEC had already done that work for Securities Act Section 5—with Regulation S.

[14] The definition of "distribution" as used in Securities Act § 2(a)(11) is generally considered to be synonymous with a "public offering." *Gilligan, Will & Co. v. SEC*, 267 F.2d 461, 466 (2d Cir. 1959).

Morrison confirms the analysis of *Chinese Consolidated* and *North American Research*, and nothing in *Morrison* disturbs the "generally accepted [principle] that different considerations apply to the extraterritorial application of the antifraud provisions than to the registration provisions of the Securities Act." *Offshore Offers and Sales*, 55 F.R. at 18309 (citations omitted); *cf. Nat'l Secs.*, 393 U.S. at 466 ("[T]he meaning of the words 'purchase or sale' in the context of [Exchange Act] § 10(b)" must be considered in the context of that Act, and may have a different meaning than "these or similar words…in the numerous other contexts in which they appear in the securities laws," such as "sale" and "offer" for purposes of the Securities Act.). To the contrary, in citing favorably Regulation S's definition of what constitutes "domestic" and "foreign" for purposes of the Securities Act, the *Morrison* Court recognized and reaffirmed this distinction.

D. Defendants Engaged in a Public Distribution of Securities That Failed to Comply with Regulation S.

Regulation S provides that "the terms offer, offer to sell, sell, sale, and offer to buy shall be deemed to include offers and sales that occur within the United States and shall be deemed not to include offers and sales that occur outside the United States." 17 C.F.R. § 230.901. The Rule provides conditions under which "[a]n offer or sale of securities by the issuer, a distributor, [or] any of their respective affiliates…shall be deemed to occur outside the United States within the meaning of § 230.901." *Id.* § 230.903(a). As set forth below, Regulation S's proscriptions are consistent with the long-understood focus of Securities Act Section 5 on the entire process by which securities find their way from issuers to public investors, and prohibits the type of conduct that courts have for years held violates Section 5, if it occurs in the U.S.

To avail themselves of these provisions, issuers and their affiliates must take steps not to engage in a public distribution in which securities come to rest in the hands of U.S. investors. First, there must be no "directed selling efforts…in the United States by the issuer, a distributor, [or] any of their respective affiliates." *Id.* §§ 230.903(a)(1)-(3), (b)(2)(i), (b)(3)(i). "'Directed selling efforts' means any activity undertaken for the purpose of, or that could reasonably be expected to have the effect of, conditioning the market in the United States for any of the securities being offered in reliance on this Regulation S." *Id.* § 230.902(c)(1). And the issuer and affiliate must engage in "offshore transactions" only and implement "[o]ffering restrictions." "Offshore transactions" requires that no offer be "made to a person in the United States." *Id.* § 230.902(h)(1)(i). "Offering restrictions" are aimed to prevent the resale of securities sold offshore to U.S. persons and require "statements to the effect that the securities…may not be offered or sold in the United States" in all offering materials and documents. *Id.* § 230.902(g)(2). Thus, a compliant foreign offering must prevent flow-back of securities to U.S. markets and investors.

Defendants' offers and sales of XRP undisputedly did not qualify as "foreign" under Regulation S. Ripple and Defendants were engaged in directed selling efforts to U.S. investors and took no steps to prevent XRP from landing in their hands. Among other things, (1) Defendants failed to take any steps to ensure that XRP would not be sold to U.S. investors, *e.g.*, ¶¶ 174, 177 (Larsen); 184, 186 (Garlinghouse); (2) Defendants in fact offered and sold XRP to U.S. investors, *e.g.*, ¶¶ 178 (Larsen); 187 (Garlinghouse); and (3) Defendants and Ripple all made extensive "offers" of XRP to U.S. investors—including through marketing statements on Ripple's website, Twitter account and YouTube channel, and interviews on U.S.-based finance programs, all discussing the risks and potential rewards of buying XRP—and in fact created a U.S. public market for XRP into which their XRP ultimately came to rest. *E.g.*, ¶¶ 113, 174, 177-78, 265, 300 (Larsen); 184, 186-87, 253-256, 261-62, 266, 278-79, 307-11, 326, 337, 345-349 (Garlinghouse); 60, 115-16, 119, 160, 190, 193 (both); 197-202, 217, 257-29, 264, 267-68, 271-72, 275, 301, 323-34, 331-336, 340 (Ripple).

Defendants failed to meet the conditions of Regulation S and engaged in numerous acts that violated Section 5 *in the U.S*. The fact that title to XRP may have passed abroad (an issue that is in dispute and best resolved on a full factual record as set forth below at Part II.E), is irrelevant. *E.g.*, *Chinese Consolidated*, 120 F.2d at 738; *North Am. Res. Dev. Corp.*, 424 F.2d at 81; *see also Rubin*, 449 U.S. at 430 (passage of title not needed to constitute offer or sale). Stated differently, the conduct relevant to Section 5's focus—conditioning and selling into U.S. markets—occurred in the U.S. This case therefore involves a permissible domestic application of the statute even if some of Defendants' conduct occurred abroad. *WesternGeco*, 138 S. Ct. at 2137.

Defendants urge the Court to ignore Regulation S because the "SEC could not – even if it wanted to – expand the extraterritorial reach of the Securities Act beyond what Congress itself prescribed," Garlinghouse Br. at 28; *see also* Larsen Br. at 27. This argument is circular, as it is premised on the conclusion Defendants wish to advance—that their offers and sales were "foreign," and, therefore, that Regulation S does not or cannot apply. Moreover, as the SEC stated when it promulgated Regulation S, its purpose was to *limit* the scope of Section 5 to "domestic" offers and sales, which it accomplished by exercising its statutorily delegated authority to *interpret* Section 5. *See Offshore Offers and* Sales, 55 F.R. at 18307; *Morrison*, 561 U.S. at 268-69 ("[T]he [SEC] has interpreted" Section 5 in Regulation S). Defendants themselves recognize this insofar as they argue that "Regulation S does not even purport to regulate foreign transactions." Garlinghouse Br. at 29.

The same is true as to Defendants' contention that the SEC seeks to "open foreign exchanges to U.S. regulation." Garlinghouse Br. at 30; *see also* Larsen Br. at 27. This is not an enforcement action against non-U.S. digital asset trading platforms. The SEC seeks to enforce Section 5 as to Defendants' U.S. conduct—offering and selling the U.S. securities of a U.S. issuer into U.S. capital markets to U.S. investors. It is critical to the purposes of the Securities Act, *see supra* at § II.B, that U.S. investors have access to the full disclosure provided by registration in order to make an informed investment decision. That Defendants used both domestic and foreign conduits to violate the law does not and should not permit Defendants to so easily evade the application of the federal securities laws' registration requirements.

Finally, it is unclear how or why the fact that Regulation S pre-dates *Morrison*, as Defendants point out, has any relevance. To the contrary, the *Morrison* Court took guidance from Regulation S precisely because Regulation S already defined the territorial scope of Securities Act Section 5 by the time the Supreme Court did the same for Exchange Act Section 10(b). 561 U.S. at 268-69.

E. *Morrison* and the Securities Act Belie Defendants' Other Arguments.

Defendants' arguments that the Section 5 claim pleads foreign "offers and sales" is premised on a single fact—that *some* (but, as even Defendants admit, not all) of their XRP was sold on digital asset platforms owned by companies located outside the U.S. According to Defendants, Section 5's scope is limited to the moment when unregistered XRP "sales were made…on foreign exchanges," Garlinghouse Br. at 21; Larsen Br. at 24 ("Sales completed on foreign exchanges are not captured by Section 5(a)"), which they view as occurring when "title was transferred." Larsen Br. at 23 (citation omitted); *see also* Garlinghouse Br. at 21.

This argument is mistaken for two reasons. *First*, it ignores *Morrison*'s admonition that a court must study the "focus" of a particular statute and its interrelated provisions to determine if a case involves a proper domestic application of the relevant statute. As the decades of case law and additional arguments below show, there is no reason to think that *Morrison's* transactional-based test—crafted for Exchange Act Section 10(b) and based upon that provision's "in connection with the purchase or sale of any security" language—applies to Securities Act Section 5's expansive focus, which does not even require passage of title for liability to attach. *See Rubin*, 449 U.S. at 430; *Pinter*, 486 U.S. at 643. *Second*, even assuming *Morrison*'s transactional test *was* a good fit for Section 5 (it is not), Defendants misapply even that test to this case for the reasons set forth in Section II.F below.

Defendants' attempt to import *Morrison*'s Exchange Act Section 10(b) transactional test into Securities Act Section 5 claims is contrary to *Morrison* itself. As noted, the Supreme Court has said that one must first identify the statue's "focus" to determine the proper test to apply. *Morrison*, 561

U.S. at 266-67; *RJR Nabisco*, 136 S. Ct. at 2101; *WesternGeco*, 138 S. Ct. at 2137. Defendants do not even attempt this exercise, but their contention that the "offers" at issue are merely "post[ed]" on "[f]oreign exchanges," Garlinghouse Br. at 26, is simply untenable. *See also* Larsen Br. at 26-27. As noted, Section 5's focus is much broader than this unduly narrow reading of Section 5, which covers the full scope of a public offering, not just the moment title passes. *See supra* Argument § II.B.

In *Morrison* itself, the Supreme Court decided whether Exchange Act Section 10(b)'s prohibition on deceptive conduct "in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered" covered fraudulent statements made in connection with purchases by Australian citizens of the securities of an Australian corporation on an Australian stock exchange. 561 U.S. at 251-53 & n.1. At the first step of the analysis the Court held that, given Exchange Act Section 10(b)'s focus on "transactions" on a "national securities exchange," the statute does not apply extraterritorially. *Id.* at 262-65. At the second step, the Court developed a two-prong test to determine if the application of Exchange Act Section 10(b) to particular transactions constituted a permissible domestic application of the law. If the transaction at issue occurred on U.S. national securities exchanges *or* constituted "domestic transactions in other securities" (a term the Court did not define), *id.* at 266-67, then the case involved a permissible domestic application of Exchange Act Section 10(b); otherwise, it did not.

Section 5's focus contrasts sharply with Exchange Act Section 10(b)'s, another reason to conclude that *Morrison*'s transactional test is ill-suited for determining whether a case involves a proper domestic application of Securities Act Section 5. Whereas Securities Act Section 5 focuses broadly on all aspects of a public distribution of securities, Exchange Act Section 10(b) focuses only on deceptive conduct "in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered." 15 U.S.C. § 78j(b). The Supreme Court itself has recognized the distinction between the transactional language of Exchange Act

Section 10(b) and Securities Act Section 5's focus on the offering process. In *SEC v. National Securities*, the Supreme Court explained that "Congress itself has cautioned that the same words may take on a different coloration in different sections of the securities laws; both the [Securities Act] and the [Exchange Act] preface their lists of general definitions with the phrase 'unless the context otherwise requires'." 393 U.S. at 466 (citations omitted). Accordingly, the Court refused to use a rule enacted under Securities Act Section 5 to interpret the scope of Exchange Act Section 10(b), noting that the question before the Court was limited "to the meaning of the words 'purchase or sale' in the context of [Section] 10(b) [ ] [w]hatever these or similar words may mean in the numerous other contexts in which they appear in the securities laws." *Id.*

The lower courts have noted the contrasting focuses of the two provisions as well. As the Fifth Circuit explained:

> The purpose of the registration provisions of the [Securities] Act is to provide adequate disclosure to members of the investing public, and that of [Exchange Act Section 10(b)], to protect investors from the use of manipulative or deceptive devices in securities transactions [such that] the meaning of the terms 'sale' and 'purchase and sale' under different sections of the [Securities Act and Exchange Act] may vary.

SEC v. Continental Commodities Corp., 497 F.2d 516, 527-28 (5th Cir. 1974) (citations omitted). Again, Securities Act Section 5 liability may attach even if no sales occur, or even if the sale does not violate the statute. *E.g.*, *Cavanagh*, 155 F.3d at 135 ("[A]n offer in violation of Section 5(c) constitutes an independent offense…regardless of whether a sale occurs or the conditions of that sale.").[15]

For these reasons, the cases cited by Defendants are all inapposite. In each, only sales were presented, such that none of these courts had occasion to address the broader scope of acts covered by Section 5—the question squarely presented in this case.

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[15] It is thus unremarkable that, as Defendants point out, courts have applied *Morrison*'s transactional test to Securities Act Section 17(a) which, similar to Exchange Act Section 10(b), focuses on fraud "in the offer or sale" of securities. 15 U.S.C. § 77q(a)(2). Even in those cases, the courts draw a distinction between "offers" and "sales" subject to Securities Act Section 17(a). *E.g.*, *SEC v. Goldman Sachs & Co.*, 790 F. Supp. 2d 147, 165 (S.D.N.Y. 2011) (dismissing "sales" claims not "offer" claims under Section 17(a) against defendant who marketed investment from New York).

For example, *SEC v. Bio Defense Corporation* involved securities offered overseas, from foreign call centers to foreign citizens, but the court nevertheless held that the SEC *could bring* suit under *Morrison* because the completion of the sales transaction occurred upon signing a document in the U.S. No. 12 Civ. 11669, 2019 WL 7578525, at *12 (D. Mass. Sept. 6, 2019), *aff'd sub nom. SEC v. Morrone*, No. 19-2006, __ F.3d __, 2021 WL 1850551 (1st Cir. May 10, 2021). *Schentag v. Nebgen* is even further afield, as it involved a private right of action under Securities Act Section 12, which requires an actual purchase of securities to establish liability. No. 17 Civ. 8734, 2018 WL 3104092, at *5 (S.D.N.Y. June 21, 2018); *see also* 15 U.S.C. § 77*l*(a). No such requirement exists in an SEC enforcement action under Securities Act Section 5.

Defendants' arguments fare even worse when they invoke the "predominantly foreign" language in *Parkcentral Global Hub Ltd. v. Porsche Auto Holdings SE*, 763 F.3d 198 (2d Cir. 2014), and *Cavello Bay Reinsurance Ltd. v. Shubin Stein*, 986 F.3d 161 (2d Cir. 2021). Both *Parkcentral* and *Cavello Bay* (neither of which involved Section 5) involved a non-U.S. defendant and the foreign securities of a non-U.S. issuer, where both sides to the transactions were institutional investors that chose the application of non-U.S. law in their agreements. *E.g.*, *Cavello Bay*, 986 F.3d at 167; *see also Morrone*, __ F.3d __, 2021 WL 1850551, at *6 (rejecting application of *Parkcentral* and *Cavello Bay* to promoters of the stock of a U.S.-based company who "conducted nearly all of their activities in furtherance of the fraud from the U.S.," and holding that such conduct was domestic under *Morrison*). To the extent *Parkcentral* and *Cavello Bay* apply, they show the need to impose Section 5 liability on Defendants' unregistered distribution because it involved a public offering by a U.S. corporation and its U.S. affiliates of a U.S. security to retail U.S. investors, where liability requires no completed contract.[16]

[16] Defendants improperly insist that the Court weigh the evidence and make factual findings at the motion to dismiss stage, arguing that the Complaint shows that the trades were "executed…through a foreign Market Maker and on foreign exchanges." Garlinghouse Br. at 30; Larsen Br. at 24. These are incorrect recitations of the facts the Court must

F. Even if *Morrison*'s Transactional Test Applied, the Complaint Pleads Transactions that Satisfy It.

1. *Morrison*'s Transactional Test Must Apply to All Sales in Defendants' Public Distribution of XRP.

Even if *Morrison*'s transactional test were the proper method to determine the scope of Securities Act Section 5's registration requirement, the court must consider *all* the transactions at issue in Defendants' public distribution of XRP securities, including the resales of XRP to U.S. investors on U.S. markets (which indisputably satisfy *Morrison*) and not just Defendants' own sales during one stage of this multi-step distribution process. In *SEC v. Telegram Group, Inc.*, the issuer—a foreign corporation—made unregistered offers and sales of digital asset securities to both U.S. and foreign investors, and argued—as Defendants do—that *Morrison* barred the application of Securities Act Section 5 to sales of the digital asset securities of the foreign issuer, by the foreign issuer to a foreign investor. No. 19 Civ. 9439, 2020 WL 1547383, at *1 (S.D.N.Y. Apr. 1, 2020). Judge Castel rejected the argument and explained that the court had to consider "the entire scheme," which included "the intended resale of Grams by Telegram's conduits into the secondary market [which] is likely to involve U.S. purchasers," and that such secondary sales to U.S. purchasers "would likely satisfy *Morrison's* transactional test." *Id.* at *1 (citing *Morrison*, 561 U.S. at 269-70).

Telegram's analysis of *all* the transactions that constitute the public distribution of Ripple's securities by Defendants is consistent with the Second Circuit's holding that "if any person involved in a transaction is a statutory underwriter, then none of the persons involved may claim exemption under Section 4[(a)](1)." *Kern*, 425 F.3d at 153. In other words, in a "transaction with multiple stages," the "defendants' role in orchestrating the transaction while they were affiliates" subjects them to Section 5 liability even if they were no longer involved when "the unregistered sales

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deem true for purposes of these Motions. The Complaint alleges that Defendants' own offers and sales—which cannot be understood independent of Ripple's—occurred on at least four U.S.-based trading platforms as well as on other non-U.S. based trading platforms. ¶¶ 177, 186. Defendants' offers and sale were part of a worldwide distribution of securities. It is the U.S. portion of this worldwide offering that the SEC seeks to regulate.

occurred," *SEC v. Cavanagh*, 445 F.3d at 115, because a defendant does "not have to be involved in the final step of the distribution to have participated in it." *Geiger*, 363 F.3d at 487.

2. The *Morrison* Transactional Test is Satisfied Even with Respect to Each Individual Sale by the U.S. Defendants on non-U.S. Platforms.

Even assuming *Morrison*'s transactional test for Exchange Act Section 10(b) applied to Securities Act Section 5 claims (which it does not), the Complaint pleads domestic offers and sales of XRP by Defendants under that test. As noted, transactions can meet *Morrison*'s transactional test in one of two ways: either because the transaction occurred on a "national securities exchange" in the U.S., or because it constituted a "domestic transaction in other securities." 561 U.S. at 266-67. The first method is a "bright-line test"—the transaction either occurred on a domestic exchange or did not. *Absolute Activist Value Master Fund Ltd. v. Ficeto*, 677 F.3d 60, 68 (2d Cir. 2012) (citation omitted). The second method, can itself be met in one of two ways—by showing "irrevocable liability was incurred" or "title [to the shares] was transferred" in the U.S. *Id.*; *see also Loginovskaya v. Batratchenko*, 764 F.3d 266, 273-74 (2d Cir. 2014) ("there are two ways to allege a 'domestic transaction'" under Section 10(b) (citing *Absolute Activist*)). Irrevocable liability may be determined based many factors, including the location of the "formation of the contracts, the placement of purchase orders, the passing of title, or the exchange of money." *Absolute Activist*, 677 F.3d at 69-70.

To the extent any of the U.S. digital asset trading platforms used by Defendants are the types of "national securities exchanges" contemplated by *Morrison*, offers and sales on those platforms meet the first prong.[17] Moreover, all sales on all digital asset trading platforms meet the second prong because Defendants incurred irrevocable liability in the U.S.

[17] None of the digital asset platforms on which Defendants sold XRP are registered with the SEC as "exchanges." ¶ 94; *see also* 15 U.S.C. § 78e. Thus, it is far from clear that any sales on these platforms—either U.S. or non-U.S.—may be analyzed under *Morrison*'s bright-line prong. *E.g.*, *Myun-Uk Choi v. Tower Rsch. Cap. LLC*, 890 F.3d 60, 67 (2d Cir. 2018) (explaining that *Morrison*'s first prong was based on Exchange Act Section 10(b) language focus on "national securities exchange[s]"); *United States v. Georgiou*, 777 F.3d 125, 134-35 (3d Cir. 2015) (noting that the Exchange Act refers separately to "securities exchanges" and "over-the-counter markets," and that the SEC's webpage of registered exchanges does not include OTCBB or the Pink Sheets, and holding that those platforms are therefore not "national securities exchanges"). The Court need not resolve this question because *all* transactions meet *Morrison*'s second prong.

First, and contrary to Larsen's argument that the "SEC does not plead that any of Mr. Larsen's XRP sales occurred on a domestic exchange," Larsen Br. at 23, the Complaint alleges that at least some of Defendants' transactions of millions of XRP occurred on *at least five* digital asset trading platforms incorporated in the U.S. ¶¶ 177, 186. These transactions squarely satisfy *Morrison's* bright-line test under Defendants' own reading of the test, or, at a minimum, they satisfy *Absolute Activist*, because these allegations suffice to infer that irrevocable liability attached in the U.S. *E.g.*, *Myun-Uk Choi*, 890 F.3d at 67 (allegation that a trade cleared on a U.S.-based platform sufficient to meet irrevocable liability test even if the security was listed on a non-U.S. based platform).

Defendants nevertheless insist that this allegation is insufficient to plead domestic transactions because one cannot infer from the fact that the transactions occurred on U.S.-based platforms that "irrevocable liability" for those sales occurred in the U.S. However, this argument conflates the first way of meeting *Morrison*'s transactional test with the second. Offers and sales on U.S. platforms are by definition "domestic" under *Morrison*'s first prong (bright-line test), and no *additional* allegations to prove the second prong (irrevocable liability test) are required. Thus, all of the cases Defendants cite in support of the argument that the SEC does not allege domestic sales even as to U.S.-based platforms are cases interpreting the *second Morrison* prong, not the first, and none involved transactions on domestic trading platforms or suggest that allegations about irrevocable liability are necessary to meet the bright-line test. *See, e.g.*, *Lognovskaya*, 764 F.3d at 274-75 (involving private transactions of sales); *Banco Safra S.A. Cayman Islands Branch v. Samarco Mineracao S.A.*, __ Fed. App'x __, 2021 WL 825743, at *2 (2d Cir. Mar. 4, 2021) (involving "secondary aftermarket transactions" and thus the second prong of the *Morrison* test).

Moreover, even if allegations relating to the second method of meeting *Morrison*'s test were required to meet the first, that certain transactions occurred on domestic platforms is enough to plausibly infer that title passed in the U.S. That inference is certainly more plausible than a contrary supposition—that U.S.-based platforms would "pass" the digital assets on foreign servers.[18]

Second, transactions that occurred on the digital asset platforms these particular Defendants used all doubly satisfy *Morrison*'s second prong, because Defendants and the U.S. purchasers of XRP incurred irrevocable liability for these transactions in the U.S.

In *Absolute Activist* itself, the Second Circuit explained that an off-exchange transaction is "domestic" under Morrison if ***either*** "the purchaser incurred irrevocable liability within the United States to take and pay for a security," ***or*** "the seller incurred irrevocable liability within the United States to deliver a security." 677 F.3d at 68. The Court of Appeals later explained that the inquiry into where either side incurred irrevocable liability does not turn on contract-law principles or where "a contract is said to have been executed." *United States v. Vilar*, 729 F.3d 62, 77-78 n.11 (2d Cir. 2013). Rather, "territoriality under *Morrison* concerns *where, physically,* the purchaser or seller committed him or herself." *Id.* (emphasis added). In *Vilar*, the Second Circuit illustrated this idea with the example of a foreign seller who sent an offer to sell securities to a person in Puerto Rico. That seller would incur irrevocable liability in the U.S. even though, under Puerto Rican law, any resulting contract would be governed by the foreign law where the offer originated. *Id.*

Morrison and *Absolute Activist* allow that "the parties may be bound at two separate times and locations," such that where "the evidence demonstrates that at least one party…was acting from the United States,…the transactions are domestic under *Morrison*." *SEC v. Ahmed*, 308 F. Supp. 3d 628, 669 (D. Conn. 2018). And, once a party becomes irrevocably bound in one jurisdiction, the fact that another party still has to perform an act (perhaps in another country) to deliver the securities or otherwise complete the transaction does not place the transaction outside of the reach of the federal

[18] Moreover, Defendants seek to have it both ways. They want the Court to infer that title to securities traded on U.S.-based platforms *does not* pass in those platforms' place of incorporation (the U.S.), but also want the Court to infer the opposite as to securities traded on non-U.S. platforms—that title *does* pass in the foreign locale.

securities laws if those circumstances are "entirely out of [the seller's] control and depended solely on subsequent actions taken by" third parties. *Giunta v. Dingman*, 893 F.3d 73, 81 (2d Cir. 2018).

These principles are consistent with a consensus that has developed in the U.S. under the Uniform Electronic Transactions Act ("UETA") for determining the situs of a purchase or sale based on electronic communications. 15 U.S.C. § 7001 *et. seq.* Under the UETA, which California (the jurisdiction of Defendants' principal place of business) has adopted, Defendants' electronic communications into the automated sales system of non-U.S. trading platforms—necessary to irrevocably commit them to sell XRP—are deemed sent from their place of business, California. *See* ¶¶ 16-18, 176, 185; *see also* Cal. Civil Code § 1633.15(d) ("Unless otherwise expressly provided in the electronic record or agreed between the sender and the recipient, an electronic record is deemed to be sent from the sender's place of business."); UETA § 15(d).

Under these principles, even the second prong of *Morrison*'s transactional test is satisfied in at least one of two ways. First, Defendants became irrevocably bound to sell their XRP when they transmitted their sell orders to the market makers from their offices or residences in California, so *Morrison* is satisfied because the seller incurred irrevocable liability in the U.S. *See also Naftalin*, 441 U.S. at 773 (transmittal of order to sell may violate Securities Act Section 5). Second, even if Defendants somehow became irrevocably bound on the non-U.S. exchanges, the *purchasers* of Defendants' XRP that were U.S. purchasers became irrevocably bound in the U.S., making Defendants indistinguishable from the would-be seller in *Vilar* (sitting abroad but transmitting an offer to sell into Puerto Rico), which the Second Circuit concluded satisfies *Morrison*.

Defendants ignore the foregoing principles and would reduce even the "irrevocable liability" test to the place a digital asset platform's parent company incorporates. *E.g.*, Garlinghouse Br. at 23;

Larsen Br. at 24.[19] This argument is the mirror image of the erroneous argument Defendants make to avoid liability as to transactions on U.S.-based platforms. As to those transactions, Defendants would impose the requirements of *Morrison*'s second prong (irrevocable liability) on the first (the bright-line test). Here, as to transactions on other platforms, Defendants would collapse the first *Morrison* prong into the second, rendering the "irrevocable liability" test superfluous. Thus, while Defendants cite cases dealing with *Morrison*'s second prong to contend with trades that meet its first prong, here, they confusingly rely on cases dealing with *Morrison's* first prong to contend with its second. *E.g.*, *Plumbers' Union Loc. No. 12 Pension Fund v. Swiss Reinsurance Co.*, 753 F. Supp. 2d 166, 178 (S.D.N.Y. 2010) (transactions on a foreign, national securities exchange, the SWX Swiss Exchange, not addressing irrevocable liability) (cited in Garlinghouse Br. at 24; Larsen Br. at 25); *In re Vivendi Universal, S.A. Sec. Litig.*, 765 F. Supp. 2d 512, 532-33 (S.D.N.Y. 2011) (transactions on a foreign, national securities exchange, the Paris Bourse, not addressing irrevocable liability).

Defendants' argument is foreclosed by *Myun-Uk Choi*, where the Second Circuit applied the "irrevocable liability" test to transactions in securities listed on a non-U.S. trading platform. As the Second Circuit explained, "*Morrison* clearly provided that the 'domestic transaction' prong is an independent and sufficient basis for application of the Securities Exchange Act to purportedly foreign conduct. *Morrison* summarized the standard in the disjunctive: '[W]hether the purchase or sale is made in the United States, *or* involves a security listed on a domestic exchange.'" 890 F.3d at 67 (citing *Morrison*, 561 U.S. at 269-70). Thus, the court held that sufficiently plausible allegations that irrevocable liability occurred in the U.S. were enough to withstand a motion to dismiss under *Morrison*, notwithstanding that the securities were listed on a non-U.S. trading platform.

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[19] As a preliminary matter, it is wholly nonsensical to speak, as Garlinghouse does, of a physical "location" for a digital asset exchange that operates by definition on a network of computers distributed around the planet.

Defendants' argument also relies on incomplete factual assumptions (not presently before the Court) about how XRP transactions actually occur. The Complaint alleges that Defendants disposed of their XRP when they transmitted it from the U.S. to the Market Maker. ¶¶ 174, 183. To the extent that is the "sale" to which *Morrison*'s transactional test should apply, Defendants incurred irrevocable liability to dispose of (and did dispose of) their XRP when they transmitted instructions, signed by their associated "private keys," to the XRP Ledger to transfer their XRP to the Market Maker, which the Court may infer based on UETA occurred from Defendants' principal place of business—California.

To the extent the relevant sale is between the Market Maker and a purchaser on a non-U.S. based platform (which may be a U.S. investor, since many of these platforms have worldwide operations, *see id.*), the question of when "title passed" is more complicated than Defendants would allow, and further illustrates the pitfalls of trying to squeeze this case into *Morrison*'s transactional test. To the extent a "sale" on a non-U.S. digital asset trading platform occurs "on-chain," ¶ 35—*i.e.*, actually on the XRP Ledger—the transfer is final when it is written to the XRP Ledger and validated by the blockchain's consensus mechanism. This process is achieved, not on the servers of the digital asset platforms, but on the network of computers that "validate" new blocks for the XRP Ledger based on a system of consensus. *See supra* at 4. Today, at least 40% of these network computers are operated by Ripple or other U.S.-based entities, ¶¶ 39-41, and the number was above 80% at the time of some of Defendants' sales. At the motion to dismiss stage, title to digital assets represented on blockchain may plausibly be understood to pass within the U.S. when, like the XRP Ledger, the digital ledger is operated primarily from the U.S. *See In re Tezos Sec. Litig.*, No. 17 Civ. 6779, 2018 WL 4293341, at *8 (N.D. Cal. Aug. 7, 2018) (noting allegations that the Ethereum blockchain consisted of a "global network of 'nodes' clustered more densely in the United States than in any other country," which was sufficient to satisfy *Morrison*'s transactional test).

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Defendants' arguments require ignoring *Morrison*'s admonition that the threshold step is to determine the "focus" of a statutory provision. They would effectively repeal the Securities Act's registration requirements *sub silentio* by permitting a U.S. issuer to condition U.S. capital markets and raise capital from U.S. investors but avoid providing the information that for nearly 80 years Congress has required when issuers seek to raise U.S. investor funds, by the trick—as simple as it gets in today's digital world—of trading the security on both U.S. and non-U.S. digital platforms. Section 5's broad provisions are designed to prevent such a result. *See North Am. Res. Dev. Corp.*, 424 F.2d at 71.

III. <u>THE CLAIMS FOR MONETARY RELIEF AGAINST LARSEN ARE TIMELY.</u>

The SEC seeks monetary relief—disgorgement and civil penalties—for Larsen's violations. *See* 15 U.S.C. §§ 77t(d), 78u(d)(7). Under the statute of limitations applicable to claims for monetary relief based on Larsen's Section 5 violations, the SEC may recover for violations that occurred five years before the September 1, 2020 date of its tolling agreement with Larsen, ¶ 429—that is, for conduct between September 1, 2015 and the filing of the Complaint. *See id.* § 78u(d)(8)(A)(i).[20]

Larsen argues, however, that the SEC cannot recover *any* of the $450 million in XRP sales proceeds he netted, ¶ 86, because he first violated the statute in 2013 and the statute of limitations expired in 2018, given that he and Ripple engaged in a years-long unregistered offering of securities.

But Larsen committed a discrete violation of Section 5 with *each* unregistered offer and *each* unregistered sale. *E.g.*, *Cavanagh*, 155 F.3d at 133. Accordingly, for statute of limitations purposes, "a series of repeated violations of an identical nature" renders each violation "actionable for five

[20] The five-year limitations period for the offenses at issue in this case was enacted by Section 6501(a) of the National Defense Authorization Act for Fiscal Year 2021 ("NDAA"), Pub. L. 116-283, 134 Stat. 3388 (Jan. 1, 2021). It was previously set forth in 28 U.S.C. § 2462, as interpreted in *Gabelli v. SEC*, 568 U.S. 442 (2013), and *Kokesh v. SEC*, 137 S. Ct. 1635 (2017). Larsen is correct that the SEC does not argue that the NDAA's *ten-year* period applies to the request for *monetary relief*. *See* 15 U.S.C. § 78u(d)(8)(A)(ii). It *does* apply to the SEC's requests for injunctions, which Larsen does not allege are untimely, *id.* § 78u(d)(8)(B), as the SEC informed Larsen's counsel by letter dated February 3, 2021.

years after its occurrence." *SEC v. Kokesh*, 884 F.3d 979, 985 (10th Cir. 2018) (citation omitted); *see also SEC v. Pentagon Capital Mgmt. PLC*, 725 F.3d 279, 286, 288 n.7 (2d Cir. 2013) (finding it appropriate to "count[ ] each late trade as a separate violation" where defendants perpetrated a late trading "scheme"). The SEC could not have had "a complete and present cause of action," *Gabelli*, 568 U.S. at 448 (citation omitted), as to each XRP offer and sale until Larsen made each one.

Despite Larsen's argument (*see* Larsen Br. at 29-30), there is no inconsistency between the SEC's characterization of his conduct as repetitive and continuous in nature and the SEC's request for monetary relief for each unlawful offer and sale. After all, the Second Circuit held in *Cavanagh* that each offer and each sale requires registration, while also recognizing that Section 5's provisions are expansive and cover the entire offering process. 155 F.3d at 135. Nor is there any inconsistency in describing conduct as a single distribution involving multiple, discrete offers and sales.

SEC v. Jones, the only case involving Securities Act Section 5 that Larsen cites, provides no support for his proposition that the SEC may not obtain monetary relief for the illegal sales he made even a few weeks before the Complaint's filing. 300 F. Supp. 312 (D. Mass. 2018). That case involved a court finding, upon a full review of the factual record and not on a motion to dismiss, that the SEC had only offered evidence that the defendant was involved in sales that occurred in 2007 and not enough evidence that he was involved with sales that had occurred during the five years before the case was filed. *Id.* at 316-18. The court did *not* dismiss the claims as time-barred on the theory that Larsen advances—that the statute of limitations began to run on the date of the *first* sale—even though the case also involved claims of violative offers that spanned years. *Id.* at 314.

CONCLUSION

For the foregoing reasons, the Court should deny Defendants' Motions.

Dated: New York, New York
May 14, 2021

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UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION, Plaintiff, -against- RIPPLE LABS INC., BRADLEY GARLINGHOUSE, and CHRISTIAN A. LARSEN, Defendants.	20 Civ. 10832 (AT) (SN) ORAL ARGUMENT REQUESTED

REPLY MEMORANDUM OF LAW IN SUPPORT OF DEFENDANT BRADLEY GARLINGHOUSE'S MOTION TO DISMISS THE AMENDED COMPLAINT

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Cases

Defendant Bradley Garlinghouse respectfully submits this memorandum of law in further support of his motion to dismiss with prejudice (ECF No. 111) (the "Motion") the SEC's amended complaint (ECF No. 46) (the "AC") for failure to state a claim pursuant to Fed. R. Civ. P. 12(b)(6).

PRELIMINARY STATEMENT

The SEC's Opposition (ECF No. 183) ("Opp.") is an elaborately-staged yet ultimately futile effort to obscure the pleading deficiencies identified in Mr. Garlinghouse's motion to dismiss. The SEC still fails – after two attempts – to plead core elements of its claims, and now seeks to move the goalposts by asking this Court to convert aiding and abetting into a strict liability offense (it is not), ignore binding Supreme Court and Second Circuit precedent, accept a mischaracterization of its own regulation and its application, and rely on misleading quotes from documents that facially defeat, rather than support, its theory of the case against Mr. Garlinghouse.

The SEC brought an exceedingly aggressive and unprecedented – and ultimately legally flawed – case against Ripple in December 2020 on the basis that XRP should have been registered as a security back in 2013 and remains a security today. This whole litigation is largely about that question, which is far from straightforward even now. The agency's decision to take a further leap by charging Ripple's current CEO, Mr. Garlinghouse, with a scienter-based offense that would require that he knew or recklessly disregarded that he was helping Ripple violate the law or otherwise act improperly from the moment he set foot at the company in 2015 as its Chief Operating Officer, defies plausibility. To prevail, the SEC would have to show, at a minimum, that it was *obvious* to Mr. Garlinghouse in 2015 and thereafter that Ripple's sales of XRP were improper. Yet the only even potential impropriety the SEC alleges is that Ripple's sales violated Section 5 of the Securities Act. Thus, to state a claim for aiding and abetting, the SEC must plead that Mr. Garlinghouse knew or that it was obvious to him years ago that Ripple was issuing securities when it sold XRP.

The AC does not just fail to make these allegations, but it establishes that it was demonstrably *not* obvious to Mr. Garlinghouse, or for that matter to any of the market makers, exchanges or other regulators who for years concluded that XRP was not a security. Nor was it obvious to the SEC, which surely would have acted before December 22, 2020 to stop an "obvious" unregistered securities offering. So it is no surprise that, despite reviewing thousands of emails and other private internal communications and deposing Mr. Garlinghouse, the AC pleads *nothing* that would support an inference that Mr. Garlinghouse's subjective view was any different than the public statements he made consistently explaining not only that XRP was not a security but why it was not. The SEC is left only with allegations that Mr. Garlinghouse recognized the general *risk* that sales of certain digital assets could be classified as securities, and that he sought to ensure that Ripple's communications about XRP sales did not convey a misimpression about what Ripple was selling when it sold XRP. That is not aiding and abetting under the correct legal standard.

The SEC has no answer for its inability to plead that Mr. Garlinghouse knew or was reckless as to whether Ripple's XRP sales violated the securities laws or were otherwise improper. And so it seeks to persuade the Court that something less is required. The Court should decline the invitation. The SEC itself has acknowledged in other cases, and the case law is clear, that secondary actors are liable for aiding and abetting *only* where their conduct is knowing or reckless. That the SEC cannot plead knowledge or recklessness – in a case involving the sale of an entirely new species of asset (cryptocurrency) and where the lack of regulatory clarity is well documented – is no justification for lowering the standard for liability. It is confirmation that the SEC's aiding and abetting claim never should have been brought and cannot proceed.

The SEC's Section 5 claim against Mr. Garlinghouse also fails because the AC identifies no allegations of domestic offers or sales of XRP. The SEC cannot avoid the characteristics of the transactions it is challenging by simply declining to allege any facts about them. The law is well-established – only properly pleaded domestic offers and sales can support potential Section 5 liability. To mask these pleading deficiencies, the SEC tries to turn the law on its head by arguing that this Court should be the first to accept that the territorial scope of the Securities Act is defined not by the Supreme Court's decision in *Morrison v. National Australia Bank Ltd.*, 561 U.S. 247 (2010), but rather by the SEC's own Regulation S, which was adopted 20 years before *Morrison*. Worse, the SEC misreads Regulation S, which explicitly anticipated that non-domestic offers and sales were beyond the reach of Section 5. Finally, the SEC's fallback argument – that every single offer and sale, even those executed by a foreign market maker on foreign exchanges, falls within the territorial reach of the Securities Act if any *conduct* occurred in the U.S. – is precisely what *Morrison* and its progeny in this Circuit foreclosed.

ARGUMENT

I. THE SEC HAS NOT PLEADED AND CANNOT PLEAD SCIENTER

A. The SEC Mischaracterizes Mr. Garlinghouse's Arguments and Misstates the Legal Standard for Scienter

The Opposition mischaracterizes Mr. Garlinghouse's argument for dismissal of the aiding and abetting claim. Mr. Garlinghouse does not argue "that the SEC must allege that Defendants knew that XRP was in fact a security *as a matter of law*." Opp. at 28. Rather, the SEC must plead that Mr. Garlinghouse knew or recklessly disregarded that Ripple's offers and sales of XRP were *improper*. Mot. at 18-20. The SEC has accepted this "improper" requirement in prior federal litigation, *see* Mot. at 19, in its own administrative proceedings, *id.*, and in this very case, *see* Op. & Order, ECF No. 103, at 3 (Apr. 9, 2021) (holding, on a discovery motion the SEC did not appeal, that "the SEC must show that the Individual Defendants knew or recklessly disregarded that

Ripple's offerings and sales of XRP required registration as securities *and that those transactions were improper*.") (emphasis added).[1]

The SEC recognizes that the AC does not plead that Mr. Garlinghouse knowingly or recklessly associated himself with anything improper, so instead the SEC now argues that it need only plead "knowledge of the circumstances that constitute the primary violation." Opp. at 25. That would transform aiding and abetting into a strict liability violation by allowing the SEC to premise an aiding and abetting claim solely on Mr. Garlinghouse's knowledge that Ripple was selling an unregistered digital asset (XRP), without also pleading that he knew or was reckless that there was anything wrong with doing so. That is not the law. *See* 15 U.S.C. § 77o(b) (requiring that a defendant act "knowingly or recklessly"); *see SEC v. Yorkville Advisors, LLC*, 305 F. Supp. 3d 486, 511 (S.D.N.Y. 2018) ("[T]he plaintiff must at least demonstrate recklessness to satisfy the knowledge requirement. . . . Mere negligence does not suffice.").[2]

The SEC has no answer to the cases holding that aiding and abetting liability can only arise where the defendant recognizes or is reckless as to the impropriety of the alleged conduct. Mot. at 18-19 (citing *SEC v. Paulsen*, No. 18 Civ. 6718 (PGG), 2020 WL 1911208, at *5 (S.D.N.Y. Apr. 18, 2020); *SEC v. Espuelas*, 905 F. Supp. 2d 507, 518 (S.D.N.Y. 2012)). Indeed, as the SEC itself acknowledged in litigating *Paulsen*, the legal standard requires that a defendant "knew, consciously avoided knowing, or was reckless in not knowing that his role was part of an overall activity that was improper." SEC's Post-Trial Memorandum at 2*, SEC v. Paulsen*, No. 18 Civ.

[1] *See Hamlen v. Gateway Energy Servs. Corp.*, No. 16 CV 3526 (VB), 2018 WL 1568761, at *2 (S.D.N.Y. Mar. 29, 2018) (prior determination of a legal issue by a magistrate judge was law of the case on later motion to dismiss before the district judge).

[2] The SEC's quotation of *SEC v. Hurgin*, 484 F. Supp. 3d 98, 112-13 (S.D.N.Y. 2020), for the proposition that "scienter . . . arguments are not appropriate for resolution on a motion to dismiss" is misleading. The full quote is "Hurgin argues that the Commission cannot establish that he acted with scienter, but his arguments are not appropriate for resolution on a motion to dismiss." *Id.*

6718 (PGG) (S.D.N.Y. Aug. 14, 2020), ECF No. 148; *see also Espuelas*, 905 F. Supp. 2d at 518 (requiring that defendant had sufficient knowledge "to appreciate that [his activity] under the circumstances was improper").

Instead, the SEC argues that out-of-circuit authority or criminal fraud cases somehow command a different result here. They do not. *SEC v. Falstaff*, 629 F.2d 62 (D.C. Cir. 1980), which the SEC relies on heavily, is entirely consistent with the "improper" requirement, as recognized by courts in this District. *See SEC v. Mattessich*, 18 Civ. 5884 (KPF), 2021 WL 797669, at *9 (S.D.N.Y. Mar. 1, 2021) (citing *Falstaff* and holding that defendant must have "kn[o]w[n] that his particular arrangement ran afoul of [prohibitions on the payment of undisclosed commission compensation]" to incur aiding and abetting liability). And criminal fraud cases establish only that a defendant charged with fraud is understood to have associated himself with impropriety by virtue of signing up *to a fraud*, whether or not he is aware that the object of the fraud is a security. *United States v. Brown*, 578 F.2d 1280 (9th Cir. 1978); *United States v. Leonard*, 529 F.3d 83 (2d Cir. 2008). By contrast, in this civil case, the only *mens rea* that the SEC alleges would distinguish between sales of XRP being proper and improper would be the knowledge that registration as a securities offering was required.

B. The AC Does Not and Cannot Plausibly Allege That Mr. Garlinghouse Recklessly Disregarded that Ripple's Sales and Offers of XRP Were Improper

None of the allegations about Mr. Garlinghouse in the AC meet the "improper" requirement. Amid irrelevant allegations about others, the SEC's arguments relating to Mr. Garlinghouse consist only of short statements essentially regurgitating the allegations of the AC. *See In re Aegean Marine Petrol. Network, Inc. Sec. Litig.*, 18 Civ. 4993 (NRB), 2021 WL 1178216, at *35 (S.D.N.Y. Mar. 29, 2021) ("Scienter must be separately pled and individually supportable as to each defendant; scienter is not amenable to group pleading."). Stripped of the SEC's argumentative gloss, these statements show nothing more than that Mr. Garlinghouse was generally following regulatory developments in the cryptocurrency space and taking efforts to ensure that Ripple's conduct was proper in a highly-uncertain regulatory environment. *See* Mot. at 13-18. Many of the SEC's allegations relate to events that occurred or information received prior to his even joining the company. And, despite the extensive pre-complaint discovery afforded to the SEC, the AC does not allege any statement by Mr. Garlinghouse even suggesting he believed that XRP was a security.

None of the SEC's four categories of allegations about Mr. Garlinghouse, Opp. at 27-28; *see also id.* at 11-15, is "separately pled and individually supportable" to state a claim that Mr. Garlinghouse aided and abetted Ripple's alleged Section 5 violation.

First, allegations that Mr. Garlinghouse knew that Ripple did not register its offers and sales would be relevant only if Mr. Garlinghouse knew or was reckless that offers and sales of XRP *actually were* a securities offering or were otherwise improper.

Second, while the SEC cites 45 paragraphs of the AC for the proposition that Mr. Garlinghouse "promoted XRP as [investment contracts]," Opp. at 27, that is not what the AC actually alleges. Rather, the AC alleges that Mr. Garlinghouse knew that Ripple was selling XRP, and that some were buying XRP because they thought the price would rise. But, as the SEC itself concedes, allegations that an asset was purchased for speculative purposes does not establish that it is a security. Opp. at 33 n.10 (disclaiming the argument that "XRP was an investment contract . . . *simply* because it was purchased for speculation"); *see also Sinva, Inc. v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 253 F. Supp. 359, 367 (S.D.N.Y. 1966) ("The mere presence of a speculative motive on the part of the purchaser or seller does not evidence the existence of an 'investment contract' within the meaning of the securities acts."). People buy all sorts of things – from diamonds to collectibles – in the expectation that their value will increase; not all (or even most) of those things are securities. *Cf.* 15 U.S.C. § 77e; *see SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946). The SEC repeatedly confuses Mr. Garlinghouse's alleged knowledge that XRP was an asset with value and utility with supposed knowledge that it was a security.[3]

Third, the SEC alleges that Mr. Garlinghouse was aware of the risk that "such offers and sales *could be improper* under certain circumstances." Opp. at 27 (emphasis added). But it is not enough to allege that this conduct "could be improper"; to adequately plead recklessness, the SEC must plausibly allege that there was "an unjustifiably high risk of harm that is either known or so obvious that it should be known." *Farmer v. Brennan*, 511 U.S. 825, 836 (1994). In any event, the SEC ignores that the very documents it relies on to establish those allegations show that, in words and deeds, Mr. Garlinghouse distinguished Ripple and XRP from those sales of other digital tokens that he understood could be securities offerings. *See* Mot. at 13-14 (citing cases holding that a defendant's recognition of generalized risks does not constitute recklessness). While the Opposition asserts that Mr. Garlinghouse "was . . . warned by advisors" that "offers and sales [of XRP] could be improper under certain circumstances," Opp. at 27, it misrepresents the documents the AC actually relies upon:

- The SEC asserts that Mr. Garlinghouse received "warnings" that XRP had "securities-type" characteristics, Opp. at 13, 30 (quoting AC ¶ 407), but the quoted document makes clear "Ripple's position that XRP is not a security," and that the focus of the email was to ensure that XRP would not be incorrectly perceived as a security, *see* Ex. K; AC ¶ 407 ("[W]e do need to hone our playbook/messaging.").

- The SEC relies on notes taken by a potential investor in Ripple equity to assert that Mr. Garlinghouse said he could "not guarantee" that XRP was not a security. Opp. at 15, 30.

[3] The SEC insinuates that Mr. Garlinghouse's statement that he was "long XRP" was somehow misleading or deceptive (neither of which is pleaded); but Mr. Garlinghouse by any measure was and is "long XRP" – he received part of his employment compensation in XRP, and he held and holds significant amounts of XRP. AC ¶¶ 87, 181. The SEC cannot and does not point to any statement by Mr. Garlinghouse denying that he sold XRP.

The SEC omits the exculpatory portion of these notes, which state in full that Mr. Garlinghouse "feels optimistic that the SEC will rule" that XRP will not be classified as a security but "cannot guarantee that," and that "it should be [a] pretty straight forward decision" that XRP is not a security. *See* Ex. L; AC ¶ 420.

- Similarly, the SEC misleadingly asserts that Mr. Garlinghouse "also was concerned with 'verbiage' in communications that could make 'XRP sound[] like a security,'" Opp. at 30-31 (quoting AC ¶ 408), but the quoted document is an email from the head of Ripple HR *to* Mr. Garlinghouse noting in the context of offer letters to new employees that their "verbiage doesn't put us at risk of XRP sounding like a security," *see* Ex. M.

And while the SEC contends that Mr. Garlinghouse "knew that the status of XRP under the securities laws was of keen interest to the digital asset platforms," Opp. at 28, it omits that over 200 digital asset platforms concluded XRP was not a security because they listed XRP on their platforms, *see* Mot. at 14; *see also* Op. & Order, ECF No. 210, at 5 (May 30, 2021).

Fourth, the SEC argues that the mere fact that Mr. Garlinghouse's "financial interests were aligned with Ripple's" is enough to plausibly allege scienter. Opp. at 26-28. But a long line of Second Circuit authority has rejected compensation-based motives as a basis for alleging a corporate officer defendant's scienter. *See ECA & Local 134 IBEW Joint Pension Tr. of Chi. v. JP Morgan Chase Co.*, 553 F.3d 187, 198, 201 (2d Cir. 2009) ("Motives that are common to most corporate officers, such as . . . the desire to keep stock prices high to increase officer compensation, do not constitute 'motive' for purposes of [the scienter] inquiry."); *Kalnit v. Eichler*, 264 F.3d 131, 139-40 (2d Cir. 2001) (citing cases holding the same).[4]

The SEC's demand that the Court not weigh its factual allegations, Opp. at 31-34, is misplaced and incorrect. Mr. Garlinghouse is not asking the Court to resolve fact disputes – he is

[4] Characterizing Mr. Garlinghouse's compensation as a "concrete and personal benefit" in no way distinguishes his situation from any other corporate executive in America. *See Wyche v. Advanced Drainage Sys., Inc.*, 710 F. App'x 471, 473 (2d Cir. 2017) ("Bonus compensation is not the type of 'concrete and personal' benefit upon which a finding of motive to commit securities fraud can be based") (quoting *Kalnit*, 264 F.3d at 139); *Reilly v. U.S. Physical Therapy, Inc.*, 17 Civ. 2347 (NRB), 2018 WL 3559089, at *12 (S.D.N.Y. July 23, 2018) ("[E]ven multi-million dollar bonuses that plaintiffs alleged were directly tied to misstatements were insufficient evidence of motive.").

asking the Court to look at the AC's allegations made after more than 30 months of investigation and to evaluate whether they plausibly allege that he knowingly or recklessly joined Ripple to help further an illegal scheme. *See Whiteside v. Hover-Davis, Inc.*, 995 F.3d 315, 323-25 (2d Cir. 2021) (granting 12(b)(6) motion where plaintiff's "allegations do not permit a plausible inference that Defendants *willfully* violated the statute – whether by actual knowledge or . . . by reckless disregard" where it "pleads facts that are merely consistent with Defendants' purported willfulness and . . . stops short of the line between possibility and plausibility."); *see also Biro v. Conde Nast*, 807 F.3d 541, 545 (2d Cir. 2015) ("Rule 8's plausibility standard applies to pleading intent.").

II. THE SEC DOES NOT ALLEGE THAT MR. GARLINGHOUSE'S PERSONAL OFFERS OR SALES OF XRP OCCURRED IN THE UNITED STATES

Under Supreme Court precedent, the SEC has the burden to plausibly allege that Mr. Garlinghouse engaged in domestic offers or sales of XRP. *Morrison*, 561 U.S. at 268-69. The SEC alleges that there was "a discrete violation of Section 5 with each unregistered offer and each unregistered sale," Opp. at 59,[5] but it does not allege a single domestic offer or sale by Mr. Garlinghouse.

A. *Morrison* Applies to the SEC's Section 5 Claims

The SEC's primary argument is simply to reject controlling precedent it finds unhelpful, arguing that the transactional test in *Morrison* does not apply to Section 5 claims. Opp. at 48. The SEC cites no court in any jurisdiction that has reached this conclusion, and fails to identify a single case that held *Morrison* does not apply to *any* section of the Securities Act. *See* 561 U.S. at 268 ("The same focus on domestic transactions is evident in the Securities Act of 1933, 48 Stat. 74,

[5] *See also* Hr'g Tr. 45:10-12 (Mar. 19, 2021) ("So their sales, every time [Mr. Garlinghouse and Mr. Larsen] sold and failed to register the transaction, unless they point to an exemption, they violated Section 5 individually, irrespective of Ripple's violation.").

enacted by the same Congress as the Exchange Act, and forming part of the same comprehensive regulation of securities trading."). It also ignores cases in this District and elsewhere uniformly applying *Morrison* to Securities Act claims, including Section 5 claims.[6]

B. Regulation S Does Not Supplant *Morrison*

The SEC's secondary argument is that *Morrison* does not apply because its own administrative regulation – Regulation S – provides the "proper criteria" for determining "what constitutes domestic 'offer[s]' and/or 'sale[s]' of securities under Section 5." Opp. at 37. But the SEC cannot expand the territorial scope of a statute by regulation, so if Regulation S leads to a different conclusion than would result from applying *Morrison* to Section 5 of the Securities Act, the regulation would have to yield. *See Chevron, U.S.A., Inc. v. Nat. Res. Def. Council*, 467 U.S. 837, 842-43 (1984); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 (1976) ("Thus, despite the broad view of the Rule advanced by the Commission in this case, its scope cannot exceed the power granted the Commission by Congress under [Section] 10(b).").

In any event, the plain text of Regulation S defeats the SEC's argument. The SEC relies on two different sections of Regulation S:

- Section 901 is a "general statement" that "the terms offer, offer to sell, sell, sale, and offer to buy shall be deemed to include offers and sales that occur within the United States and shall be deemed not to include offers and sales that occur outside the United States." 17 C.F.R. § 230.901.

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[6] *See* Mot. at 20-21; *SEC v. Bio Def. Corp.*, No. 12-11669-DPW, 2019 WL 7578525, at *11-13 (D. Mass. Sept. 6, 2019) (applying *Morrison* to Section 5 claim), *affirmed sub nom. SEC v. Morrone*, 997 F.3d 52, 59 (1st Cir. 2021) ("Under [*Morrison*], the federal securities laws apply to only two types of transnational transactions: (1) "transactions in securities listed on domestic exchanges," and (2) "domestic transactions in other securities."); *Schentag v. Nebgen*, No. 1:17-CV-8734-GHW, 2018 WL 3104092, at *5, 10-13 (S.D.N.Y. June 21, 2018) (applying *Morrison* to Section 5 claim); *In re Smart Techs., Inc. S'holder Litig.*, 295 F.R.D. 50, 55-56 (S.D.N.Y. 2013) ("Courts in this District uniformly concur that *Morrison*'s prohibition on extraterritoriality applies to Securities Act claims."); *see also SEC v. Revelation Cap. Mgm't*, 246 F. Supp. 3d 947, 952-53 (S.D.N.Y. 2017) (rejecting the SEC's argument that *Morrison* does not apply to Rule 105 of Regulation M).

- Section 903 provides a "non-exclusive" safe harbor that issuers and others can – but need not – rely on to engage in foreign securities offerings while eliminating the risk they might be found to be domestic. 17 C.F.R. § 230.903.

The SEC conflates the two sections by referring to them together as "Regulation S," but they have very different purposes. While the SEC argues that *Morrison* somehow recognized that "Regulation S properly defines the scope of what constitutes 'domestic' and 'foreign,'" Opp. at 44, it ignores that *Morrison* cites *only* to Section 901 for the unremarkable proposition that the SEC had interpreted Section 5 "not to include . . . sales that occur outside the United States." 561 U.S. at 269. *Morrison* does not cite to Section 903, and nothing in the decision suggests that *only* an offering that satisfies the Section 903 safe harbor is outside the scope of Section 5. The SEC's argument also defies its own interpretative guidance, which makes clear that an offer or sale can occur outside the United States (as Section 901 recognizes) "*regardless* of whether the conditions of the safe harbor are met." Offshore Offers & Sales, SEC Release No. 122, 1990 WL 311658, at *6 (Apr. 24, 1990) (emphasis added); *see Eur. & Overseas Commodity Traders, S.A. v. Banque Paribas London*, 147 F.3d 118, 125 (2d Cir. 1998), abrogated on other grounds by *Morrison*, 561 U.S. 247 ("A transaction not within either of the safe harbors may still be outside of the United States within the meaning of 17 C.F.R. § 230.901."). That has to be true, otherwise issuers, brokers, and underwriters offering foreign securities on foreign exchanges – and those purchasing them – would be subject to the U.S. securities laws, which is what *Morrison* expressly foreclosed. 561 U.S. at 263 ("Nothing suggests that this *national* public interest pertains to transactions conducted upon *foreign* exchanges and markets.").

C. Section 5 "Focuses" on Domestic Sales and Offers for the Purpose of the Presumption Against Extraterritoriality

The SEC concedes, as it must, that Section 5 does not apply extraterritorially. Opp. at 39. The SEC must therefore show that this case involves a domestic application of Section 5. *Morrison*

561 U.S. at 266-67; *Absolute Activist Value Master Fund Ltd. v. Ficeto*, 677 F.3d 60, 66 (2d Cir. 2012). Rather than plead domestic offers or sales, the SEC tries to argue that Section 5's scope covers not only offers and sales themselves, but rather "the *entire* process of distributing securities from an issuer to the public," Opp. at 41, even if the relevant offer or sale occurred abroad. But if that were true, it would mean that the registration requirements of the securities laws have a *broader* territorial scope than the anti-fraud provisions, which apply only when a transaction occurs on a U.S. exchange or irrevocable liability is incurred within the United States. *Morrison*, 561 U.S. at 267. That is obviously wrong: Even before *Morrison* repudiated the so-called "conduct and effects" test in favor of a transactional test, *id.* at 255-61, the Second Circuit "clearly state[d]" that the registration requirements of the Securities Act (including Section 5) have a more limited extraterritorial reach than the anti-fraud provisions. *Eur. & Overseas Commodity Traders*, 147 F.3d at 123, 125 (collecting cases).

The SEC's interpretation seeks to roll the law backwards, and would mean that any "conduct" in the United States leading to a securities offer or sale implicates Section 5. But the "conduct and effects" test is precisely what the Supreme Court rejected in *Morrison*. 561 U.S. at 255-61; *see also* Mot. at 24-27. The law is clear that Section 5 is focused not on the entire "process of distributing securities," as the SEC argues, *see* Opp. at 41, but rather it is "transaction-specific." *SEC v. Cavanagh*, 155 F.3d 129, 133 (2d Cir. 1998); *see also Allison v. Ticor Title Ins. Co.*, 907 F.2d 645, 648 (7th Cir. 1990) ("Section 5 (the registration requirement) applies to transactions; each sale must be registered or exempt. A violation does not stick to the instruments like tar.").[7] Tellingly, the only support the SEC identifies for its argument that the focus of Section 5 is the

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[7] *Morrison* and its progeny have held that for such transaction-specific provisions of the Securities Act and Exchange Act, the "focus" is "not upon the place where the deception originated," but rather on "purchases and sales of securities in the United States." 561 U.S. at 266-68.

"entire offering process" are pre-*Morrison* cases that determined whether a defendant had sufficient involvement in a distribution of unregistered securities for liability to attach, and whether the Section 4(a)(1) exemption applied. Opp. at 44 (citing *SEC v. Kern*, 425 F.3d 143, 153 (2d Cir. 2005); *Geiger v. SEC*, 363 F.3d 481, 487 (D.C. Cir. 2004)). These cases do not support the SEC's position that offers or sales that occurred abroad fall under Section 5 as long as some conduct occurred in the U.S. *See Morrison*, 561 U.S. at 266 ("[T]he presumption against extraterritorial application [of the federal securities laws] would be a craven watchdog indeed if it retreated to its kennel whenever some domestic activity is involved in the case.").

D. The AC Fails To Plead Any Domestic Offers or Sales under Section 5

Having repeatedly tried to dodge the issue, the SEC's fallback position – which at least is the correct inquiry – is that the AC plausibly alleges domestic offers and sales of XRP under *Morrison*'s transactional test. *See* Opp. at 52-58. But the Opposition does not contest two critical points that foreclose this argument under binding authority: (i) the SEC has the burden to plead domesticity, which is a substantive element of its Section 5 claim under *Morrison*, 561 U.S. at 253-54, and (ii) the AC contains no non-conclusory allegations that any of Mr. Garlinghouse's specific transactions are domestic, *Absolute Activist*, 677 F.3d at 70 ("Absent factual allegations suggesting that the [Defendants] became irrevocably bound within the United States or that title was transferred within the United States . . . the mere assertion that transactions 'took place in the United States' is insufficient to adequately plead the existence of domestic transactions.").

The SEC concedes that none of Mr. Garlinghouse's transactions in XRP occurred on a domestic exchange because "[n]one of the digital asset platforms on which [he] sold XRP are registered with the SEC as 'exchanges.'" Opp. at 53 & n.17. That leaves only *Morrison*'s second prong, which requires the SEC to "allege facts indicating that irrevocable liability was incurred or that title was transferred within the United States." *Absolute Activist*, 677 F.3d at 62. The SEC argues that its allegation that "at least some of" Mr. Garlinghouse's transactions "occurred on *at least five* digital asset trading platforms incorporated in the U.S." is sufficient "to infer that irrevocable liability attached in the U.S." Opp. at 54. It is not. Under controlling precedent, the SEC must plead specific allegations regarding the transactions, such as "facts concerning the formation of the contracts, the placement of purchase orders, the passing of title, or the exchange of money." *Absolute Activist*, 677 F.3d at 70. Nor do the SEC's assertions that the term "offer" is afforded a broad interpretation, Opp. at 41, carry any weight. The SEC does not allege that Mr. Garlinghouse advertised, solicited, or otherwise let it be known that he was willing to sell XRP domestically; nor that offers of XRP made by a foreign market maker on Mr. Garlinghouse's behalf on foreign exchanges occurred in the United States. Mot. at 26-29.

The SEC's attempts to point to domestic *conduct* or ties do not pass muster under *Morrison*. The possibility of "resales of XRP to U.S. investors on U.S. markets," Opp. at 52, does not domesticate Mr. Garlinghouse's foreign offers or sales. *See Absolute Activist*, 677 F.3d at 67 (holding that the time for assessing territoriality is the moment "when the parties become bound to effectuate the transaction.").[8] California's enactment of the Uniform Electronic Transactions Act ("UETA") is irrelevant given the SEC's failure to allege "communications into the automated sales system" of foreign platforms by Mr. Garlinghouse. *See* Opp, at 56. Rather, the SEC alleges that Mr. Garlinghouse's foreign offers of XRP were made on his behalf by a foreign market maker. AC ¶ 183. Nor does state law control the territorial scope of Section 5. *See United States v. Vilar*, 729 F.3d 62, 77 n.11 (2d Cir. 2013). And, even if Mr. Garlinghouse's electronic communications

[8] Dicta in *SEC v. Telegram Grp. Inc.*, No. 19-cv-9439 (PKC), 2020 WL 1547383, at *1 (S.D.N.Y. Apr. 1, 2020), that the initial coin offering at issue in that case "would likely satisfy *Morrison*'s transactional test," does not stand for the broad proposition that a third-party purchaser's resale of XRP in the U.S. could somehow turn initial sales on foreign exchanges into domestic transactions.

were deemed to be sent from California, the "mere placement" of an order in the United States is not sufficient to establish that irrevocable liability was incurred domestically. *City of Pontiac Policemen's & Firemen's Ret. Sys.*, 752 F.3d 173, 181 & n.33 (2d Cir. 2014).

The SEC's conjecture that some of the people who purchased XRP on foreign exchanges might have been Americans does not save its claim. Even if the SEC had pleaded that, the Second Circuit has held that a "purchaser's citizenship or residency does not affect where a transaction occurs." *Absolute Activist*, 677 F.3d at 69. In *Vilar*, which the SEC incorrectly avers is "indistinguishable," irrevocable liability was incurred in the United States because the fraudulent transactions were bilateral agreements between investment advisors and investors that were executed in the United States. 729 F.3d at 68-69, 76-78. No similar allegations were or could be made here. *Cf. Myun-Uk Choi v. Tower Rsch. Cap. LCC*, 890 F.3d 60, 67 (2d Cir. 2018) (finding domestic transactions where trades matched on an electronic exchange located in the U.S.).

Finally, the SEC tries to muddy the waters one last time by arguing that to the extent that Mr. Garlinghouse's sales occurred "on-chain," some portion of the network of computers involved in such transactions are operated by U.S. entities.[9] Opp. at 58. But again, the AC does not allege that Mr. Garlinghouse sold any XRP "on-chain." To the contrary, it alleges that his transactions were completed on "digital asset trading platforms or other intermediaries," which means that his offers and sales were made on the books and records of those exchanges. AC ¶ 183; *cf. In re Tezos Sec. Litig.*, No. 17-cv-06779-RS, 2018 WL 4293341, at *8 (N.D. Cal. Aug. 7, 2018) (addressing on-chain ICO tokens purchased through a website server in Arizona).

CONCLUSION

For the foregoing reasons, the amended complaint should be dismissed with prejudice.

[9] While the AC alleges that approximately 40% of nodes are operated by entities based in the U.S., it contains no allegations as to where the validators themselves are located or whether "on-chain" transactions were validated in the U.S.

Dated: June 4, 2021

Respectfully submitted,

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UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION,	:	
Plaintiff,	:	**19 Civ. 9439 (PKC)**
- against -	:	**ECF Case**
TELEGRAM GROUP INC. and TON ISSUER INC.,	:	**<u>Complaint</u>**
	:	**Jury Trial**
Defendants.	:	**Demanded**

Plaintiff Securities and Exchange Commission ("SEC" or "Commission"), for its Complaint against Defendants Telegram Group Inc. and its wholly owned subsidiary TON Issuer Inc. (together "Telegram" or "Defendants"), alleges as follows:

SUMMARY

1. The SEC brings this emergency action to stop Defendants—owners and operators of the mobile messaging application Telegram Messenger ("Messenger")—from continuing their ongoing illegal offering of digital-asset securities called "Grams." This offering is occurring in violation of the registration provisions of the federal securities laws. Defendants have committed to flood the U.S. capital markets with billions of Grams by October 31, 2019 and may do so as early as next week. Unless enjoined, Defendants will go forward without filing a registration statement for the Grams as they are required to do under the Securities Act of 1933 ("Securities

Act"). In other words, Defendants plan to sell billions of securities that will quickly come to rest in the hands of U.S. investors without providing those investors important information about their business operations, financial condition, risk factors and management.

2. Telegram's illegal offering (the "Offering") had an initial stage, which took place between January and March 2018. During this stage, Telegram raised approximately $1.7 billion from sales of approximately 2.9 billion Grams to 171 purchasers (the "Initial Purchasers"). A large portion of this capital came from U.S. investors: Telegram sold more than 1 billion Grams to 39 U.S. Purchasers, raising $424.5 million from the U.S. market. Telegram is using the proceeds of this initial offering to capitalize its business and finance the creation of its blockchain—the "Telegram Open Network" or "TON Blockchain."

3. Grams are securities because the Initial Purchasers and subsequent investors expect to profit from Telegram's work: the development of a TON "ecosystem," integration with Messenger, and implementation of the new TON Blockchain. Grams are not a currency because, among other things, there are not any products or services that can be purchased with Grams. Rather, there is an expectation on the part of investors that they will profit if Telegram builds out the functionalities it has promised.

4. Telegram committed to deliver Grams to the Initial Purchasers in conjunction with the launch of the TON Blockchain by no later than October 31, 2019 and it plans to sell millions of additional Grams at the same time. As of October 11, 2019, Telegram has not filed a registration statement with the SEC for this planned offering of securities.

5. Once Telegram delivers the Grams to the Initial Purchasers, they will be able to resell billions of Grams on the open market to the investing public. Telegram and/or its affiliates will facilitate these sales on digital-asset trading platforms. Once these resales occur, Telegram

will have completed its unregistered offering with billions of Grams trading on multiple platforms to a dispersed group of investors.

6. Sections 5(a) and 5(c) of the Securities Act require that an issuer of securities like Telegram register its offers and sales of securities with the SEC. Telegram failed to file a registration statement and plans to sell billions of Grams to investors without providing them the type of basic information about the nature of the investment being offered, information that is included in hundreds of registration statements that are filed with the SEC every year.

7. Unless enjoined, Telegram's completion of the Offering will allow it to have circumvented the Securities Act's registration requirements, leaving U.S. investors to buy and sell Grams without the vital information about those securities and about Telegram that Congress intended registration to provide.

8. Once Grams reach the public markets, it will be virtually impossible to unwind the Offering, given that many purchasers' identities will be shrouded in secrecy, and given the variety of unregulated markets where Grams may be sold, including platforms that promise anonymity and encryption capability to mask transactions. Accordingly, a temporary restraining order and preliminary injunction are necessary to prevent the imminent delivery of Grams to the Initial Purchasers (who are likely to promptly resell millions of them into the public markets) and to prevent Defendants from offering, selling, transferring, or otherwise distributing or delivering Grams to any other persons and entities absent registration pursuant to the securities laws.

VIOLATIONS

9. By engaging in the conduct set forth in this Complaint, Defendants engaged in and are engaging in the unlawful sale and offer to sell securities in violation of Sections 5(a) and 5(c) of the Securities Act [15 U.S.C. §§ 77e(a), 77e(c)].

10. Unless the Defendants are permanently restrained and enjoined, they will continue to engage in the acts, practices, and courses of business set forth in this Complaint and in acts, practices, and courses of business of similar type and object.

NATURE OF THE PROCEEDING AND RELIEF SOUGHT

11. The Commission brings this action pursuant to the authority conferred upon it by Section 20(b) of the Securities Act [15 U.S.C. § 77t(b)].

12. The Commission seeks, as immediate relief:

(1) a temporary restraining order and a preliminary injunction against Defendants prohibiting them from participating in any offerings of unregistered securities or otherwise violating Sections 5(a) and 5(c) of the Securities Act [15 U.S.C. §§ 77e(a), 77e(c)], including but, not limited to, by distributing Grams to any persons;

(2) an order permitting the Commission to conduct expedited discovery and prohibiting Defendants from destroying or altering documents; and

(3) an order permitting service by alternative means, including service on Defendants' counsel in the underlying investigation by email.

13. The Commission also seeks a final judgment: (a) permanently enjoining the Defendants from engaging in the acts, practices, and courses of business alleged herein; (b) ordering Defendants to disgorge their ill-gotten gains and to pay prejudgment interest thereon; (c) prohibiting Defendants, pursuant to Section 21(d)(5) of the Exchange Act [15 U.S.C. § 78u(d)(5)], from participating in an offering of digital securities; and (d) imposing civil money penalties on Defendants pursuant to Section 20(d) of the Securities Act [15 U.S.C § 77t(d)].

JURISDICTION AND VENUE

14. This Court has jurisdiction over this action pursuant to 28 U.S.C. § 1331 and Sections 20(b), 20(d), and 22 of the Securities Act [15 U.S.C. §§ 77t(b), 77t(d), and 77v]. Defendants, directly or indirectly, have made use of the means or instruments of transportation or communication in, and the means or instrumentalities of, interstate commerce, or of the mails, in connection with the transactions, acts, practices, and courses of business alleged herein.

15. Venue is proper in the Southern District of New York pursuant to Section 22(a) of the Securities Act [15 U.S.C. § 77v(a)]. Among other acts, Defendants sold the securities at issue in this case to purchasers with domiciles in this District, and also directed payments of funds denominated in U.S. dollars through a correspondent bank in this District.

DEFENDANTS

16. **Telegram Group Inc.** is a privately owned British Virgin Islands company with its principal place of business in Dubai, United Arab Emirates. Its primary product is Messenger, an encrypted messaging application with approximately 300 million monthly users worldwide that has been called the "cryptocurrency world's preferred messaging app."

17. **TON Issuer Inc.** is a British Virgin Islands company, wholly owned by Telegram Group Inc., with its principal place of business in Tortola.

RELATED INDIVIDUALS AND ENTITY

18. **Pavel Durov**, age 35, is a Russian and St. Kitts and Nevis citizen, and the co-founder, 100% owner, and CEO of Telegram Group Inc. In 2006, he founded a website called "VKontakte" or "VK," a social networking site similar to Facebook that later became the largest Europe-based social network. Pavel is a self-described "outspoken libertarian" who "published

free market manifestos urging the Russian government to deregulate" the economy. After a clash with the government in 2014, Pavel lost ownership of and control over VK and left Russia.

19. **Dr. Nikolai Durov**, age 39, is a Russian citizen, the co-founder, co-owner, and Chief Technology Officer of Telegram Group Inc., and Pavel Durov's brother.

20. **TON Foundation** is company that has been or is about to be incorporated as a Cayman Islands limited liability company. The TON Foundation's stated mission is to "promote and support the TON Blockchain" and includes management of Grams distributed to the TON Foundation by Defendant TON Issuer. Pavel and Nikolai Durov will be or are the sole members of the TON Foundation's board.

STATUTORY FRAMEWORK

21. Congress enacted the Securities Act of 1933 ("Securities Act") to regulate the offer and sale of securities. In contrast to ordinary commerce, Congress enacted a regime of full and fair disclosure, requiring those who offer and sell securities to the investing public to provide sufficient, accurate information to allow investors to make informed decisions before they invest. Registration statements relating to an offering thus provide public investors with financial and managerial information about the issuer and the risks and trends that would affect the enterprise.

22. Section 5(a) of the Securities Act [15 U.S.C. § 77e(a)] provides that, unless a registration statement is in effect as to a security or an exemption from registration applies, it is unlawful for any person, directly or indirectly, to sell securities in interstate commerce. Section 5(c) of the Securities Act [15 U.S.C. § 77e(c)] provides a similar prohibition against offers to sell or offers to buy, unless a registration statement has been filed or an exemption from registration applies. Thus, Sections 5(a) and 5(c) of the Securities Act prohibit the unregistered offer or sale of securities in interstate commerce absent an exemption. These prohibitions apply to a

"distribution" of securities, the entire process by which, in a public offering, a block of securities is dispersed and ultimately comes to rest in the hands of the investing public.

23. The registration statements contemplated by the Securities Act require disclosures that provide the public with the information necessary to make an informed investment decision. Disclosures in a registration statement typically require items of information concerning financial and managerial information about the issuer of the securities, details about the terms of the securities offering, the proposed use of investor proceeds, and an analysis of the risks and material trends that would affect the enterprise. They also impose on issuers a duty periodically to update this information.

24. For example, Item 3 on a Form S-1 registration statement calls for management's assessment of significant factors that make the offering speculative or risky. In addition, Rule 421(d) of Regulation S-K requires plain English disclosure (important for unsophisticated investors in a nascent or unproven tech innovation) [17 C.F.R. § 230.421(d)]. Finally, Sections 11 and 12 of the Securities Act [15 U.S.C. §§ 77k, 77*l*] impose strict liability on the issuer and underwriters of securities for false statements in registration statements.

25. Section 5 of the Securities Act, by its terms, is all embracing; it prohibits any unregistered securities offering. Through exemption provisions like Section 4 of the Securities Act [15 U.S.C. § 77(d)], however, Congress distinguished between (1) those transactions that occur during the process by which securities are distributed to the public in an offering that emanates from the issuer of the securities, and (2) subsequent trading transactions in the market by investors once the securities have come to rest with investors.

26. In drawing this distinction between distributions and trading, Congress sought to provide the protections afforded by registration both where securities are sold to the public by

the issuer, and where they are publicly sold through an intermediary who buys the stock from the issuer with a view to public resale, defined as "underwriters." 15 U.S.C. § 77b(a)(11). Congress enacted a broad definition of underwriter to include all persons who might operate as conduits for securities being placed into the hands of the investing public.

27. A distribution by issuers and/or underwriters is not exempt under Section 4 and requires registration unless some other exemption or safe harbor applies. The exemptions and safe harbors are structured to exempt transactions where the purpose and protections of registration have been otherwise satisfied. The party claiming that a distribution is entitled to an exemption bears the burden of claiming the exemption.

28. The definition of a "security" includes a wide range of investment vehicles, including "investment contracts." Investment contracts are instruments through which an individual invests money in a common enterprise and reasonably expects profits or returns derived from the entrepreneurial or managerial efforts of others. In a variety of circumstances, courts have found that novel or unique investment vehicles constitute investment contracts, including interests in orange groves, animal breeding programs, railroads, airplanes, mobile phones, and enterprises existing only on the Internet. As the U.S. Supreme Court has noted, Congress defined "security" broadly to embody a "flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."

BACKGROUND ON DIGITAL TOKENS

29. The term "digital asset" or "digital token" generally refers to an asset that is issued and transferred using distributed ledger or blockchain technology, including, but not

limited to, so-called "cryptocurrencies," "coins," and "tokens."[1] Entities have offered and sold digital tokens in fundraising events, often called "ICOs," in exchange for consideration.

30. Generally, digital tokens may entitle holders to certain rights related to a venture underlying the fundraising event, such as rights to profits, shares of assets, rights to use certain services provided by the issuer, and/or voting rights. These digital tokens may also be traded on digital-asset trading platforms where they are tradeable for other digital assets or fiat currency. The coins or tokens are often tradeable upon delivery to investors.

31. Issuers of digital tokens typically release a "whitepaper" or marketing materials describing the project and the terms of the issuance. To participate, investors typically transfer funds to the issuer's accounts. After the completion of the issuance, the issuer will deliver its unique token to the participant's unique address on a distributed ledger or blockchain.

32. In some instances, the digital tokens may continue to be sold by the issuer. In others, they may only be obtained after issuance by purchasing them in secondary markets.

33. On July 25, 2017, the SEC issued what is often called the "DAO Report," advising "those who would use . . . distributed ledger or blockchain-enabled means for capital raising, to take appropriate steps to ensure compliance with the U.S. federal securities laws," and finding that the offering of digital assets at issue in that report were investment contracts.

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[1] A blockchain or distributed ledger is a peer-to-peer database spread across a network, that records all transactions in theoretically unchangeable, digitally recorded data packages. The system relies on cryptographic techniques for secure recording of transactions. Blockchains or distributed ledgers can also record "smart contracts," essentially computer programs designed to execute the terms of a contract when certain triggering conditions are met.

FACTS

A. The Durovs Create Telegram Messenger and Plan a Public Offering of Grams

34. The Durovs launched a beta version of Telegram Messenger in late 2013, capitalizing the project with funds from Pavel and a private, Buffalo, New York-based investor. Telegram, however, does not make money from Messenger and has "declared not-for-profit" goals. Telegram tells potential users before they download Messenger that "Telegram is free and will always be free" and that Telegram is "not going to sell ads or introduce subscription fees."

35. Telegram also informs Messenger users that Telegram "take[s] your privacy seriously and will never give third parties access to your data." For example, Telegram promotes the "Secret Chats" of Messenger, which allows users to "send all types of disappearing content," and employs an infrastructure that synchronizes "encrypted data across multiple independent server[s] . . . spread across different continents and jurisdictions." Telegram similarly boasts that it has "disclosed 0 bytes of user data to third parties, including governments."

36. Messenger has become a ubiquitous messaging application for the cryptocurrency community. Telegram estimates that at least 500,000 new users join Messenger daily and recent estimates suggest that Telegram now has 300 million monthly users and that more than 84% of projects involving blockchain technology have an active community of Messenger users. Because of the privacy protections embedded in the service, Messenger has also been cited as a popular messaging app for individuals engaged in illicit activities.

37. Although Messenger incorporates ad hoc functionality that lets users exchange goods and services for both fiat and digital currency, Telegram wished to integrate the ability seamlessly to exchange digital assets directly into Messenger. The Durovs concluded, however, that existing networks such as the Bitcoin and Ethereum blockchains do not have the capability to replace high-volume transaction mechanisms like credit cards and fiat currency.

38. In late 2017, Telegram announced its intent to introduce "next-generation multi-blockchain" systems "designed to host a new generation of cryptocurrencies and decentralized applications, at a massive scale." Telegram described this yet-to-be-created "Telegram Open Network" or "TON," as "an always expanding and contracting decentralized supercomputer and value transfer system." Telegram solicited investments to fund TON's launch.

39. Telegram's decision to raise funds in the Offering coincided with a dramatic uptick in the number of "Initial Coin Offerings" ("ICOs"), fundraising events in which an entity offers participants a unique digital asset in exchange for consideration (most commonly Bitcoin, Ether, or fiat currency), and with increased market discussion of outsized returns obtained in ICOs. One service reported that at least 343 ICOs occurred in 2017, up from 43 the year prior.

40. Moreover, during that time, the overall demand for digital tokens and assets had significantly increased, and investors were aware that older digital assets (such as Bitcoin) had dramatically risen in price, generating monumental returns. The market was also aware of the increasing popularity and adoption of Messenger.

B. <u>Telegram Begins Its Intended Offering of Grams to the Public with Unregistered Offers and Sales of Billions of Grams to Initial Purchasers</u>

41. From January through March 2018, Telegram entered into Gram Purchase Agreements with the Initial Purchasers. Under the agreements, TON Issuer Inc., a wholly-owned subsidiary of Telegram Group Inc., would "issue a new cryptocurrency called 'Grams' . . . following the development and launch of a new blockchain platform" called the "TON Network." The Initial Purchasers, in turn, "subscribe[d]" to Grams by buying them at fixed prices, and Telegram committed to deliver them after the development of the TON Blockchain.

42. The Gram Purchase Agreements set October 31, 2019, as the "Deadline Date" for Telegram to fulfill its obligations to create a working blockchain and deliver Grams. If Telegram

fails to meet the Deadline Date, the Gram Purchase Agreements entitle the Initial Purchasers to reimbursement of their investment minus any expenses. Importantly, this contractual deadline is not tied to any promise or guarantee that Grams could actually be used to buy goods and services and depends solely on Telegram's ability to create and launch the TON Blockchain.

43. In early 2018, Telegram accepted Euros and Dollars in exchange for Grams.

44. Telegram's unregistered offers and sales of Grams to Initial Purchasers occurred in two phases. Telegram sold approximately 2.3 billion Grams in the first phase ("Round One"), raising $850 million, and another approximately 639 million Grams in the second phase ("Round Two"), raising another $850 million, for a total of nearly 2.9 billion Grams sold in exchange for $1.7 billion. Of the nearly 2.9 billion Grams sold, more than one billion were sold to United States purchasers, who invested a total of $424.5 million.

45. The prices at which Telegram has sold and will sell Grams during the Offering are predetermined based on a formula that Telegram created (the "Formula"), as explained below in paragraph 87. Under the Formula, Round One purchasers paid $0.37 per Gram and Round Two purchasers paid $1.33 per Gram. The "Reference Price" of Grams at launch is $3.62.

46. Telegram has not prepared or filed any registration statement with respect to any Grams it has offered or sold, or intends to offer or sell in the Offering, and no registration statement has ever been in effect with respect to any Grams.

47. The Gram Purchase Agreements did not contain information about Telegram's financial history or ability to generate profits, and purchasers who may buy or receive Grams will not receive any document containing information about Defendants' operations, financial condition, or other factors relevant in considering whether to invest in Grams. Nor will they receive information about how the Durovs are being compensated as a result of the Offering.

48. Because Telegram did not register the Offering, investors in Grams will be deprived of material information relating to their investment. Defendants essentially seek to obtain the benefits of a registered public offering without assuming the disclosure responsibilities and legal strictures designed to protect the investing public.

49. Telegram has taken the position that the Gram Purchase Agreements were investment contracts, *i.e.*, securities, and placed a restrictive legend on the Gram Purchase Agreements. The legend warned United States residents that "the offer and sale of this security has not been registered under the U.S. Securities Act of 1933" and "may not be offered, sold or otherwise transferred . . . except pursuant to an effective registration statements."

50. Telegram, however, claimed that Grams, the heart of the Gram Purchase Agreements, without which the agreements have no value or purpose, were not securities but rather currency. Telegram thus placed no restrictive legends on any Grams, nor were purchasers advised that they may not sell Grams in the United States absent a registration statement. Purchasers of Grams are not restricted from reselling them to others, other than as provided for by certain contractual lockups placed on some Grams sold to Initial Purchasers.

51. As set forth in more detail below, however, Grams are investment contracts. Based on Telegram's own promotional materials and other acts, a reasonable purchaser of Grams would view their investment as sharing a common interest with other purchasers of Grams as well as sharing a common interest with Defendants in profiting from the success of Grams. The fortunes of each Gram purchaser were tied to one another and to the success of the overall venture, including the development of a TON "ecosystem," integration with Messenger, and implementation of the new TON Blockchain. Investors' profits were also tied to Telegram's profits based on Telegram's significant holdings of Grams.

52. The Gram Purchase Agreements for Round One instituted smart contract-enforced "lock-up periods" during which purchasers could not offer, sell, or contract to sell Grams. Specifically, Round One purchasers agreed that they could not, without Telegram's prior written consent, offer, sell, or contract to sell Grams that they purchased except in a series of 25% tranches starting three months, six months, twelve months, and eighteen months after they received Grams. Round Two Gram Purchase Agreements included no such restrictions.

53. However, Grams were and continue to be investment contracts from which Initial Purchasers and others reasonably expect to reap enormous profits once the Gram market launches. Grams are not a currency because they have no realistic currency uses at this time.

54. Telegram sold and will deliver Grams in amounts that far exceed any anticipated "use" on the TON Blockchain. For example, all but three of the United States Grams Initial Purchasers bought more than 2.5 million Grams each. Nor did or will Telegram restrict sales only to individuals who would actually "use" Grams. To the contrary, Telegram contemplated that Initial Purchasers would resell their Grams immediately upon delivery, as evidenced by its inclusion of certain lock-up provisions as to some Grams.

55. Moreover, the $1.7 billion raised in the Offering so far exceeds what Defendants project they will need to develop the TON Blockchain. Indeed, Defendants stated in offering documents that the funds raised would be used for both Messenger and development of the TON Blockchain, estimating that Telegram would spend $520 million—or one-third of the funds raised—on Messenger alone between 2019 and 2021.

56. As of January 31, 2019, Defendants had used approximately $218 million of the $1.7 billion raised to support the development of Messenger and the TON Blockchain. Investors

in Grams do not exercise control over how the proceeds of the Gram sales will be spent; Telegram possesses sole discretion to decide how to do so.

C. Telegram Is Distributing Grams by Leading Investors to Expect Opportunities to Profit from Grams, Including Profits Derived from the Entrepreneurial or Managerial Efforts of Telegram

57. Telegram emphasized to investors, and some Initial Purchasers stated in communications that they understood, that Telegram, Messenger, and the Durovs were integral to the success of the TON Blockchain project and Grams.

58. In addition to private conversations between Pavel and potential purchasers, including purchasers in the United States, Telegram used certain "Offering Documents" to market, offer, and sell Grams in the Offering. The Offering Documents consisted of:

- two-page and four-page "Teasers" created sometime before the end of 2017;
- at least two versions of the "Primers" authored by Pavel Durov, varying between twenty-three and twenty-six pages in length—an undated primer created before the end of 2017 (the "2017 Primer"), and the other, entitled "Pre-Sale Primer," dated as of January 18, 2018 (the "2018 Primer");
- at least two versions of the "Whitepaper," one dated December 3, 2017 and the other January 18, 2018, a 130-plus page technical document authored by Dr. Durov; and
- at least two versions of an "IOI" sheet entitled "Telegram – Indication of Interest."

59. From the beginning of the Offering, potential purchasers received and read the various Offering Documents. Pavel himself forwarded the 2017 Primer to an individual in California, and other Telegram employees distributed the Whitepaper and Primers to potential Initial Purchasers, including in the United States (the Whitepaper, Primers, and Teasers subsequently were intentionally leaked as a part of the Offering and can currently be found on

the Internet). Pavel and Initial Purchasers signed versions of the IOI, including one with a potential purchaser who signed with an address in this District.

60. Throughout this period, Pavel marketed the sale of Grams himself, using business and other contacts to solicit investments and spread the word about the impending Offering.

Telegram Has Led Gram Purchasers to Reasonably Believe that Their Purchase of Grams Constituted an Investment into a Common Enterprise

61. The Gram Purchase Agreements themselves explained that the funds raised by the sale of Grams would be committed to "development and launch of the TON Network."

62. In the Offering Documents and in conversations Pavel had with the Initial Purchasers, Telegram led purchasers to expect that Defendants would use the Offering proceeds to finance Defendants' businesses and that Defendants and their founders would have a stake in these endeavors both because they were holding Grams and because of the inextricable connection between Grams and Messenger.

63. For example, the four-page Teaser stated that Telegram was "launching a token sale" in Q1 2018 "[t]o obtain the resources required to make TON a reality," and that Telegram would sell up to 44% of the five billion available Grams for that purpose. Telegram also stated that the remaining Grams would be reserved for its development team and the "TON Reserve," which would use Grams to "allow for a fast and stable evolution of the platform" after its launch.

64. The 2017 Primer described Telegram's need for "about $620 million to support continuing organic user growth" for Messenger, and stated that more "than 80 percent of collected funds will be spent on equipment, bandwidth, colocation, and user verification cost" and the rest "will be allocated for wages, offices, and legal and consulting services." The 2018 Primer similarly explained that Telegram intends "to use the proceeds raised from the offering

for the development of the TON Blockchain, for the continued development and maintenance of Telegram Messenger, and for general corporate purposes."

65. The Whitepaper also led investors to understand that Defendants would pool assets from the Offering to develop Telegram's envisioned products. It stated, for example, that "the TON Foundation will receive the fiat and cryptocurrency obtained by selling Grams" and "use them for the development and deployment of the TON [Blockchain]."

66. The Offering Documents made clear that the purpose of the Offering was "[t]o obtain the resources required to make TON a reality," but also to invest in Messenger itself. As the IOI stated, Telegram will "use proceeds generated by the sale of Grams to develop and launch the TON Network and develop associated functionality within Telegram Messenger."

67. And the Whitepaper similarly led investors to expect that Telegram's financial interests would be aligned with investors', including after the launch of Grams. Specifically, it spoke of the "special account" of Grams "controlled by the TON Foundation" that would be used as "rewards" for developers of the TON Blockchain. Accordingly, some gains from appreciation of the value of Grams would be reinvested into the enterprise. The IOI further linked Messenger to the success of the TON Blockchain, stating that "[i]ntegrated into Telegram's applications, the TON Wallet should become the world's most adopted cryptocurrency wallet."

68. The majority of Grams will be tradeable in the market. All investors will profit equally if the popularity and price of Grams increase, and, other than with respect to the discount on the price paid, no investor will be entitled to a higher proportion of price increases.

Telegram Led Investors to Reasonably Expect that Telegram's and Others' Entrepreneurial and Managerial Efforts Will Drive the Success or Failure of Grams and Telegram

69. Telegram also led potential investors to understand that it would be Telegram's and its principals' and agents' efforts that would determine the success of the enterprise.

70. In one of the Teasers, for example, Telegram stated that it "will use its expertise to create TON," and touted the Durovs' "over 20 years of experience in building billion dollar companies used by hundreds of millions of people" and its "Team of A-players."

71. Similarly, the Primers stated that the "Telegram Team will rely on its 10-year experience in building **user-friendly interfaces** for tens of millions to create light wallets . . . that will allow users to get on board with cryptocurrencies" and that "Telegram has a world-class team of 15 developers . . . experience[d] in building scalable projects for tens of millions." To this end, the 2018 Primer contained a four-page section describing the biographies, professional experience, and skills of these developers, and identifying the names of "notable team members."

72. The Whitepaper, moreover, contained a detailed list of projects and steps that Telegram and its principals would take to make TON a reality. This included describing at length Telegram's plans for the TON Blockchain, including why Telegram believed that its blockchain would be technologically superior to others. It also described a long list of services that Telegram would develop to improve the functionality of Messenger and of the TON Blockchain after its launch, but that, as the Whitepaper explained, Telegram had no reasonable prospect for completion in advance of the delivery of Grams.

73. The Offering Documents and other communications made clear in other ways that investors could reasonably expect Defendants' efforts for the enterprise to continue after the launch of Grams and that Telegram and/or its founders would retain a financial interest and the primary role in the success of the proposed TON even after the launch of Grams.

74. For example, with respect to unsold Grams, the Primers described the important role of the TON Foundation after the launch of Grams. The 2017 Primer explained that "[f]our percent of the supply (200 million Grams) will be reserved for the development team with a 4-

year vesting period" and at least 52% of the supply will be "retained by the TON Reserve to protect the nascent cryptocurrency from speculative trading." It also explained that the TON Reserve would transfer its Grams to the TON Foundation, and that the "founders of Telegram will be responsible for the efficient use of funds resulting from any [additional] sale[s]."

75. Like other Offering Documents, the Primers made clear that that Telegram's work would continue for some years after delivery of Grams on the new TON Blockchain and would remain critical for the foreseeable future. Both documents, for example, included a timeline specifying that the "[l]aunch of TON Services, TON Storage, and TON Proxy" would occur in the year after the "[l]aunch of Telegram Wallet." The 2017 Primer explained that Telegram's vision will not be "implemented and deployed" until "2021," and that even then "the continuous evolution of the TON Blockchain will be maintained by the TON Foundation."

76. These representations were important to purchasers who were considering whether to participate in the Offering. One such purchaser, for example, asked Pavel Durov what his own "personal ownership of tokens" would be after the Offering, because it "would help to know to ensure [his] stake is . . . fundamental[ly] aligned with the success of TON (more is better!)." The same investor also sought confirmation that "the tokens issued to employees and developers pre launch [sic]" would be "subject to the same lockup as the investors," which he viewed as "what typically happens for IPOs to ensure people needed to deliver the core intellectual property have incentives to stay engaged through the lockup."

Telegram Led Investors to Reasonably Expect a Profit from Their Investment

77. Telegram also led investors to expect that they could reap substantial profits from Telegram's efforts into their common enterprise, and took steps and is taking steps to make this expectation a reality. For example, Telegram touted a readily available trading market for Grams, including one leveraging its hundreds of millions of Messenger users; sold Grams to

Initial Purchasers at deeply discounted prices from its own projected secondary market price at launch; and promoted the future transferability of Grams into a liquid market.

78. The ability to sell investments in liquid markets is an important consideration for investors when determining whether to buy securities because it represents one way in which they can realize profits from their investments. In this case, at least one potential Initial Purchaser emailed Telegram questions about the availability of this feature.

79. The two-page Teaser, for example, told investors to expect a listing of Grams "at the major cryptocurrency exchanges" in "January – March 2019," immediately after the "December 2018 [p]rojected date for [Grams] to be issued to all investors," making Grams almost immediately sellable in open markets, including to United States investors. Telegram itself is currently in conversations with at least four digital-asset trading platforms, some of which are U.S.-based, to discuss listing Grams on their platforms.

80. On September 13, Blackmoon Crypto, a digital-asset trading platform founded by a Telegram executive and Vice President of Business Development, announced that "[t]raders will have access to Gram tokens on the Blackmoon Exchange right after [the] Telegram Open Network launch. Real on-chain Grams, available for withdrawal to Telegram native wallet. No lock-ups. No futures or other derivatives."

81. Another person, whose affiliation to Telegram is unknown but who listed himself as the "COO at the largest custod[ian] of Gram tokens (75% of the second round, 50% of the first)," contacted two popular U.S.-based digital-asset trading platforms, requesting that they list Grams. Telegram's efforts to create a trading market for Grams have thus already begun.

82. Indeed, even before the official launch of the TON Blockchain and the delivery of Grams, interests in Grams sold for as high as $4 each in secondary trading markets.

83. Telegram also repeatedly touted the Messenger user base as a ready market for the adoption of Grams. As stated in the Primers and one of the Teasers, for example, Telegram stated that it would "leverage its **existing ecosystem** of communities . . . to drive demand and value for [Grams]." Telegram further stated that, because of the large number of existing Messenger users, Grams would be accessible in 170 million wallets, compared to the "Market Cap" of Bitcoin and Ethereum, which Telegram noted were used by far fewer wallets.

84. On January 21, 2018, Pavel wrote a potential investor in the United States that Telegram planned to "leverage [its] ~200M user base to drive demand and value for a third-generation blockchain platform called TON and its principal currency Grams."

85. The Primers made similar statements, including that because the TON Wallet would be "[i]ntegrated into Telegram applications" it will "become the world's most adopted cryptocurrency wallet" and that this existing community would "drive demand" for Grams.

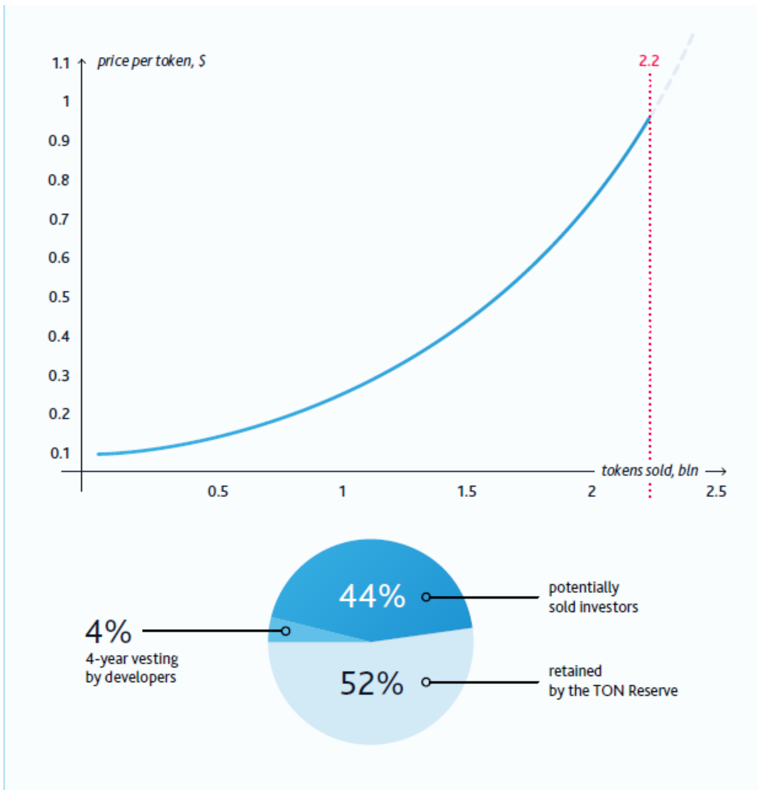
86. Telegram also led the Initial Purchasers to expect profits by selling Grams to them at deep discounts from the price Telegram told them to expect on the day of launch, thereby encouraging those purchasers to immediately distribute Grams to the public.

87. Under Telegram's Formula, Defendants would price the first Gram at $0.10, and every subsequent Gram at an amount one-billionth higher than the prior sales price. As such, Telegram designed the price of Grams to increase "exponential[ly]." Indeed, Telegram sold Grams to Initial Purchasers at a deep discount to an expected market price of $3.62 at launch.

88. Telegram repeatedly touted to potential purchasers the fact that Round One and Round Two purchasers would get a substantial discount from the eventual market price. One of the Teasers, for example, touted a potential "discount to the average public sale price [of]

68.2%." Another Teaser explained that "additional supply [of Grams] coming from the TON Foundation will always be more expensive than the price paid by any of the existing buyers."

89. In the image below, the 2017 Primer graphically illustrated the effect that the Formula would have on the price of Grams and why it dictated that the price per token would necessarily increase as sales of Gram increased.



90. The IOI and Whitepaper also led investors to expect stability and lower risk from their investment in Grams. The Whitepaper explained in detail the pricing Formula, and explained that because of the pre-arranged amounts to be transferred to the TON Foundation and the Formula, the price "of the Gram will immediately rise by a certain amount, known in advance," depending on the amounts transferred. Defendants then gave a specific example that assumes 10% of Grams are transferred to the TON Foundation and 4% for the "encouragement of the developers," resulting in "the price of the Gram[s] . . . doubling" at launch time. The net

effect of the TON Foundation's ability to buy and sell would provide a guaranteed minimum return to Initial Purchasers and reduce the losses of secondary market purchasers.

91. Throughout these statements and others, it was also clear that Defendants' efforts were and would continue to be critical in increasing the chances of these potentials for profit. As the Primers stated, "Telegram will leverage its existing ecosystem of communities, developers, . . . and merchants to drive the demand and value for [the] TON cryptocurrency."

92. In addition to the common interest that Gram investors will share in developing the TON, the Telegram development team is also needed to complete the TON Blockchain to allow Grams to achieve the value Telegram touted in the Offering Documents. Accordingly, the Whitepaper also made clear that Defendants would remain in control of the development of the TON Blockchain at least at first, recognizing that "the TON Foundation will have a majority of votes [required to make changes to TON Blockchain protocols] during the first deployment phase of the TON Blockchain."

93. The foregoing is summed up in Telegram's pitch to one United States-based investor around January 2018. Telegram spoke of its "A+ engineering team" and the "chance for 0x-50x" returns on the investments. That Initial Purchaser, in considering whether to invest in early 2018, concluded that due to the ability to "leverag[e] Telegram's 180M (and growing)" users to "bootstrap TON usage and [Gram] acceptance" there was a "plausible 10-50x return" on investments in Grams. That investor bought $27.5 million worth of Grams in early 2018 for tokens that had no use and would have no use at the time of launch, demonstrating its intent to profit from the potential increase in value of Grams.

94. In determining whether to buy Grams, this institutional investor commented on his view that the proposed products were "very ambitious and arguably too complicated," but

nevertheless noted that Grams "could be worth an investment" based on Telegram's "huge mobile presence and usability chops try[ing] to force a cryptocurrency onto their users."

95. Telegram used the same Offering Documents and Gram Purchase Agreements to market, offer, and sell Grams to all investors domiciled inside and outside the United States.

No Significant Use for Grams Exists Other than Uses Calculated to Increase Investor Profits

96. In the Offering Documents, Telegram spoke of potential future uses for Grams, specifically, as a medium of exchange for goods and services (or "cryptocurrency"), to purchase not-yet-developed tools on the TON (*e.g.*, network storage, blockchain-based domain names, identity-hiding services), and as a token for future unspecified uses that Telegram and other third parties may eventually develop. None of these uses of Grams existed at any time and Grams do not have legal tender status in any jurisdiction.

97. The Whitepaper spoke of potential future products and services that investors could use in connection with Grams, but also made clear that these products were not available at the time the Offering began and would not be available by the time Defendants delivered Grams to Initial Purchasers. Specifically, the Whitepaper described a series of services, including "TON Network," "TON Storage," and "TON Proxy," all of which would simply be parts of the technological innovations surrounding TON Blockchain. Other features, like "TON Services" would be created so that third-party users could one day create applications for the TON Blockchain "either at [its] very beginning or at a later time." Still other features like the so-called "TON Payments," a "platform for [instant] (micro) payments" using Grams, would be "likely . . . released later than the core components of the planned TON Blockchain."

98. The TON "ecosystem" did not exist and does not exist today. There are not now and have never been any products or services that can be purchased with Grams. The TON functionalities as pitched by Telegram were (and remain) entirely dependent on the funds

provided by investors. Meanwhile, the principal means by which investors would reasonably expect to profit is through their resale of Grams.

D. Telegram Intended a Public Offering of Grams from the Outset

99. Telegram has, with its offers and sales to Initial Purchasers, begun a distribution of securities, which involves the flow of securities from an issuer through conduits and out to the public at large. A large quantity of Grams—56% of all Grams currently issuable—have already been committed by Telegram to institutional and other large Initial Purchasers. Telegram's imminent planned delivery of those Grams is the next step in the broader distribution to public investors. This distribution is to be accomplished without furnishing ultimate purchasers the information about Telegram and Grams required in a registration statement.

100. The two-page Teaser shows, for example, that Telegram originally envisioned the Offering to take places in two steps in early 2018, in a "private" sale round and a public sale round—the first at $600 million and the second, public rounds at "$600M+ . . . in March 2018."

101. Telegram also made clear that it intended to distribute Grams as soon as possible. One of the Teasers, for example, stated that "the launch of the TON Blockchain . . . is expected to take place in Q4 2018." The 2017 Primer's timeline of projected events similarly demonstrated that, in early 2018, Telegram wished to distribute Grams to Initial Purchasers as quickly as possible—by Q4 2018, less than one year after the sale of Grams to Initial Purchasers.

102. Moreover, the Offering Documents made clear that Telegram envisioned from the outset that Grams needed to be held by a large number of individuals for Telegram's project to work. One Teaser, for example, noted that Telegram's "vision" included "**[a]n engaged user base** that provides pre-existing critical mass necessary for the ecosystem to grow and eventually become adopted by a [sic] hundreds of millions of users."

103. The Primers similarly made clear that the success of Defendants' project requires and envisions the rapid, widespread adoption of Grams by as many individuals as possible. Both documents speak of the "**engaged user base** that serves as the pre-existing critical mass necessary for the ecosystem to grow." Along those lines, the 2018 Primer predicts that "the TON-Telegram wallet will instantly become the world's most adopted cryptocurrency wallet."

104. As evidenced by the Offering Documents, Telegram engaged in a coordinated, centralized effort to create the Durovs' vision of a new, scalable blockchain. Defendants knew, however, that to actually implement the TON Blockchain in the real world, the project would require "numerosity": a widespread distribution and use of Grams across the globe. Indeed, by definition, the TON Blockchain can only become truly decentralized (as contemplated and promoted in the Offering Documents) if Grams holders *other than* the original Grams purchasers actually stake Grams and, thereby, act as "validators" of transactions on the TON Blockchain. Stated differently, if the original Grams purchasers alone all immediately staked their holdings, the TON Blockchain would be *centralized* rather than decentralized and, therefore, subject to misuse and majority attacks. This fundamental need for additional Grams holders demonstrates that the TON Blockchain was designed *from inception* to require the Initial Purchasers to immediately distribute their holdings to the public.

E. <u>Defendants Are Preparing to Complete Their Distribution of Grams to the Public</u>

105. In March 2019, Telegram released a beta version of the TON Blockchain, a network designed to test the functionality of TON and Grams. This was a necessary precursor for Telegram to eventually launch the TON Blockchain and deliver Grams to Initial Purchasers.

106. Telegram is preparing to imminently deliver Grams sold to Initial Purchasers, and will do so at the latest by the Deadline Date of October 31, 2019. Indeed, Telegram recently

launched the TON Wallet and, on or around October 2, gave Initial Purchasers until October 16, 2019 to provide it with a blockchain address in which to receive Grams.

107. Defendants also currently intend to set aside 500 million Grams (or approximately 10% of Grams issuable) for use as incentive payments to third-party developers of products for the TON Blockchain. They also intend to set aside 100 million Grams for the Durovs, 100 million for other Telegram developers, and the remainder—approximately 1.4 billion Grams (or approximately 28% of Grams issuable)—for other uses by the TON Foundation.

108. Defendants also intend to transfer approximately 250 million "free" Grams (of the 1.4 billion remainder) to Messenger users "in the days/weeks immediately following" the launch in order to help create a liquid market for Grams, including the Grams Telegram still holds.

109. Defendants are in the process of creating or have recently created the TON Foundation. Because the TON Foundation will have the Durovs as its sole directors, Telegram will have complete authority over all TON Foundation activities.

110. Under the terms of Telegram's agreements with the Initial Purchasers and according to its own statements, Defendants will, upon the launch of the TON Blockchain, also be able to sell Grams to public investors through select digital-asset trading platforms that Telegram has or plans to engage with, including one run and touted by a Telegram executive.

111. Grams are expected to also be immediately available on digital-asset trading platforms, including certain ones located in the United States. One popular United States-based digital-asset trading platform with which Telegram has engaged, for example, posted on its blog that it is considering whether it will sell Grams, and noted in internal documents that there is high interest from retail investors in investing in Grams.

112. Defendants have not prepared and will not file or distribute any registration statement or disclosure required under the federal securities laws to any members of the investing public in the hands of whom Grams are intended to and will come to rest.

113. Defendants failed to file a registration statement even though they cannot claim any exemption to the registration requirements of the Securities Act. The exemptions for private offerings do not apply to Grams because, among other things, the Initial Purchasers intended to resell Grams that they purchased at a steep discount to new investors. Indeed, if they could not engage in these resales, none of the Initial Purchasers' investments would be profitable.

114. Unless a registration statement is filed, the resale of Grams by the Initial Purchasers and the larger distribution of additional Grams by Telegram will violate the federal securities laws. Defendants intend to complete this violation through the distribution of billions of Grams before October 31, 2019.

115. Due to Messenger's infrastructure and other features that permit anonymous communications and transactions, once Grams are distributed to the public, it may be difficult, if not impossible, to trace who has purchased Grams and/or to know who is a current investor in Grams. Although Telegram contemplates requiring Messenger users to fulfill certain "Know Your Customer/Anti-Money Laundering" requirements for users to use future services, Telegram has stated that it "will have no access to this information." Moreover, it is uncertain whether identification of parties to transactions in the secondary market for Grams will be ascertainable.

CONCLUSION

116. The Initial Purchasers' purchases of Grams, and any subsequent purchases of Grams, were and will be an investment of money, in a common enterprise, with an expectation of profits, derived primarily from the current and future entrepreneurial and managerial efforts of

Defendants and their agents to build the TON Blockchain and drive demand for Grams. Consequently, Telegram's offer and sale of Grams to Initial Purchasers, and any upcoming, offers, sales, or distributions of Grams were and will be offers and sales of securities.

117. Telegram offered and sold securities and intends to offer and sell Grams to the public in the future. The federal securities laws require that these investors be provided with adequate disclosures regarding the investment and any of the risks associated with it.

118. Defendants' prior and future unregistered offers and sales of Grams are in violation of Section 5(a) and (c) of the Securities Act.

CLAIM FOR RELIEF
Violations of Sections 5(a) and 5(c) of the Securities Act

119. The Commission repeats, realleges, and incorporates by reference paragraphs 1 through 118, as though fully set forth herein.

120. By virtue of the foregoing, (a) without a registration statement in effect as to that security, Defendants, directly and indirectly, made use of the means and instruments of transportation or communications in interstate commerce and of the mails to sell securities through the use of means of a prospectus, and (b) made use of the means and instruments of transportation or communication in interstate commerce and of the mails to offer to sell through the use of a prospectus, securities as to which no registration statement had been filed.

121. By reason of the conduct described above, Defendants, directly or indirectly violated, are violation, and, unless enjoined will continue to violate, Securities Act Sections 5(a) and 5(c) [15 U.S.C. §§ 77e(a), (c)].

PRAYER FOR RELIEF

WHEREFORE, the Commission respectfully requests that the Court grant the following relief:

I.

An Order temporarily and preliminary, and a Final Judgment permanently, restraining and enjoining Defendants, and each of their respective agents, servants, employees, attorneys and other persons in active concert or participation with each of them who receive actual notice of the injunction by personal service or otherwise, from any ongoing and future violations of Sections 5(a) and 5(c) of the Securities Act [15 U.S.C. § 77e(a), 77e(c)], including, but not limited to, by delivering Grams to any persons, or taking any other steps to effect any unregistered offer or sale of Grams;

II.

An Order temporarily and preliminarily enjoining and restraining Defendants, and any person or entity acting at their direction or on their behalf, from destroying, altering, concealing or otherwise interfering with the access of the Commission to relevant documents;

III.

An Order providing that the Commission may take expedited discovery; and may effect service of the Complaint and the Order to Show Cause moving papers by alternative means, namely by email service on Defendants' U.S.-based legal counsel.

IV.

A Final Judgment directing each of the Defendants to disgorge all ill-gotten gains, including prejudgment interest thereon;

V.

A Final Judgment prohibiting Defendants from participating in any offering of digital asset securities pursuant to Section 21(d)(5) of the Exchange Act [15 U.S.C. § 78u(d)(5)];

VI.

A Final Judgment directing the Defendants to pay civil money penalties pursuant to Section 20(d) of the Securities Act [15 U.S.C. § 77t(d)]; and

VII.

Such other and further relief as the Court deems appropriate and necessary for the benefit of investors.

Dated: New York, New York
October 11, 2019

SECURITIES AND EXCHANGE COMMISSION

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Press Release

SEC Halts Alleged $1.7 Billion Unregistered Digital Token Offering

FOR IMMEDIATE RELEASE
2019-212

Washington D.C., Oct. 11, 2019 — The Securities and Exchange Commission today announced that it has filed an emergency action and obtained temporary restraining order against two offshore entities conducting an alleged unregistered, ongoing digital token offering in the U.S. and overseas that has raised more than $1.7 billion of investor funds.

According to the SEC's complaint, Telegram Group Inc. and its wholly-owned subsidiary TON Issuer Inc. began raising capital in January 2018 to finance the companies' business, including the development of their own blockchain, the "Telegram Open Network" or "TON Blockchain," as well as the mobile messaging application Telegram Messenger. Defendants sold approximately 2.9 billion digital tokens called "Grams" at discounted prices to 171 initial purchasers worldwide, including more than 1 billion Grams to 39 U.S. purchasers. Telegram promised to deliver the Grams to the initial purchasers upon the launch of its blockchain by no later than October 31, 2019, at which time the purchasers and Telegram will be able to sell billions of Grams into U.S. markets. The complaint alleges that defendants failed to register their offers and sales of Grams, which are securities, in violation of the registration provisions of the Securities Act of 1933.

"Our emergency action today is intended to prevent Telegram from flooding the U.S. markets with digital tokens that we allege were unlawfully sold," said Stephanie Avakian, Co-Director of the SEC's Division of Enforcement. "We allege that the defendants have failed to provide investors with information regarding Grams and Telegram's business operations, financial condition, risk factors, and management that the securities laws require."

"We have repeatedly stated that issuers cannot avoid the federal securities laws just by labeling their product a cryptocurrency or a digital token," Steven Peikin, Co-Director of the SEC's Division of Enforcement. "Telegram seeks to obtain the benefits of a public offering without complying with the long-established disclosure responsibilities designed to protect the investing public."

The SEC's complaint, filed today in federal district court in Manhattan, charges both defendants with violating the registration provisions of Sections 5(a) and 5(c) of the Securities Act, and seeks certain emergency relief, as well as permanent injunctions, disgorgement with prejudgment interest, and civil penalties.

The SEC's investigation is being conducted by Daphna A. Waxman, Morgan B. Ward Doran, and John O. Enright of the SEC's Cyber Unit. The case is being supervised by Carolyn Welshhans, Acting Chief of the SEC's Cyber Unit and Lara Shalov Mehraban, Associate Regional Director of the New York Regional Office. The SEC's litigation will be led by Jorge G. Tenreiro and Kevin McGrath.

###

Related Materials

- SEC Complaint

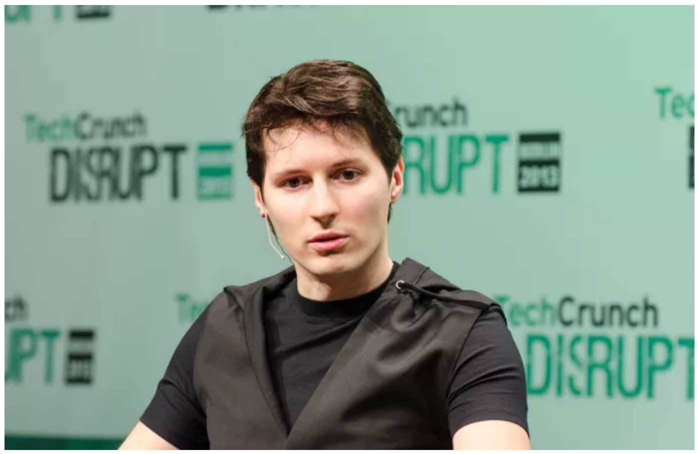
Tab 31 – Understanding Bitcoin with Mental Models

Please see the following link for the full video:
https://www.youtube.com/watch?v=56s_3LNDDqw&list=PL-DSKYgOHhD6iPITFkBCVMij_Oc2-5m-f&index=1

Story from **News**

Investors in Failed TON Project Sue Telegram

A group of investors wants compensation for the way Telegram refunded them, and is suing the company in London.



Telegram CEO Pavel Durov *(TechCrunch Disrupt Europe: Berlin 2013 via Creative Commons)*

Anna Baydakova

May 25, 2021 at 10:36 a.m. EDT
Updated May 25, 2021 at 10:56 a.m. EDT

Da Vinci Capital venture fund, which helped investors take part in Telegram's blockchain project, said some investors are suing the company for not giving them enough time to decide on how they wanted to be compensated after the project closed in April 2020.

The lawsuit against Telegram was filed in London, Da Vinci Managing Partner Oleg Zhelezko said in an interview with the Russian TV channel RBK.

Telegram shut the project, Telegram Open Network (TON), after a court battle with the U.S. Securities and Exchange Commission, offering investors partial refunds. The $1.7 billion token offering was one of the largest initial coin offerings in history. The fight with the SEC, which said the tokens, called grams, were unregistered securities, became crypto's biggest legal battle with the U.S. regulator.

"Our fund got the offer 24 hours before the deadline, and many of our investors did simply not get a chance to analyze the documents and, therefore, they were not able to get a proper return on their investments," Zhelezko said. When the project was closed, investors were getting conflicting messages and struggled to decide what to do, he said.

Telegram offered investors a choice of either receiving back 72% of their funds or lending them to Telegram for a year and receiving 110% of their investments in 2021.

Da Vinci announced plans to sue Telegram in February. According to a Forbes report in March, Telegram received a pre-lawsuit document asking for $20 million in damages.

In the sale, Telegram only allowed investors to buy significant amounts of tokens, starting with tens of millions of dollars. Smaller investors could get in only through funds like Da Vinci's, said Vladimir Smerkis, who also invested via a fund, although not Da Vinci. For such smaller investors, the withdrawal terms were not favorable.

A return of 72% "is quite a small return, especially if you take into account the fees," Smerkis said in an interview. He and some other investors decided to take the cash immediately, and he does not regret it. "We made many times more money on the growing crypto market while that lawsuit was being prepared."

Read also:* *Sidestepping Telegram, Devs and Validators Launch Fork of TON Blockchain

Earlier this year, poeple familiar with the process told CoinDesk that most investors chose to take the 72% option, but Telegram ended up with about $600 million as a loan. Investors who stayed in the deal started receiving money back in April. Prior to that, in February, Telegram sold $1 billion worth of bonds.

Zhelezko declined to comment on the case further when asked by CoinDesk. Telegram had not responded to an email seeking comment by press time.

READ MORE ABOUT...

Telegram Telegram Open Network

Related

Former SEC Chairman Jay Clayton to Advise One River Asset Management on Crypto

Clayton will join the firm's newly formed Academic and Regulatory Advisory Council along with economist Jon Orszag, and former White House adviser Kevin Hassett.

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cannot be played.
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Tanzeel Akhtar

Mar 29, 2021 at 1:45 p.m. EDT

Updated Mar 29, 2021 at 2:29 p.m. EDT

Commission (SEC) Chairman Jay Clayton has taken an advisory role at hedge fund One River Digital Asset Management, the parent company of the newly launched digital asset fund One River Digital.

In a press release on Monday, One River Digital Asset Management, which manages over $2.5 billion in institutional assets, announced Clayton will join the firm's newly formed Academic and Regulatory Advisory Council along with economist Jon Orszag, and former White House adviser Kevin Hassett.

Clayton led the SEC during its crackdown on unregistered and fraudulent initial coin offerings. During that time the commission also refused to approve the application of any bitcoin (BTC, +5.69%) exchange-traded funds and sued Ripple Labs.

backed by billionaire hedge fund manager Alan Howard and has invested $600 million in bitcoin and ether (ETH, +3.24%) for institutional clients.

The new advisory council will be tasked with assisting One River Asset Management to navigate existing policies concerning digital assets.

"The One River Academic and Regulatory Advisory Council will help us consider how these new digital systems and the investment opportunities they present will best fit within existing policy, while also helping us think through how to advance these frameworks in ways that ensure the US continues to lead the world in financial innovation and asset management," said Eric Peters, CEO of One River Asset Management.

Read more: Former SEC Chief Clayton to Chair Investment Giant Apollo

Earlier this month, Clayton was named non-executive chairman of Apollo Global Management's board of directors.

SEC Jay Clayton Advisors

One River

DISCLOSURE
The leader in news and information on cryptocurrency, digital assets and the future of money, CoinDesk is a media outlet that strives for the highest journalistic standards and abides by a strict set of editorial policies. CoinDesk is an independent operating subsidiary of Digital Currency Group, which invests in cryptocurrencies and blockchain startups.

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Goldman Sachs Settling Crypto ETPs in Europe: Sources

The U.S. bank's prime brokerage division is offering services in crypto-linked ETPs to some of its European hedge fund clients.

(Jin Lee/Bloomberg via Getty Images)

Will Canny

Jul 23, 2021 at 11:52 a.m. EDT

Updated Jul 26, 2021 at 10:59 a.m. EDT

Goldman Sachs' prime brokerage unit is clearing and settling cryptocurrency exchange-traded products (ETPs) for some hedge fund clients in Europe, according to two sources with knowledge of the matter.

The services are currently being offered to a limited number of clients, and the bank has been reviewing the matter internally as it eyes rolling out these services to a wider number of customers, the sources said.

Goldman Sachs isn't the only bank making such a move. Bank of America, as reported by CoinDesk earlier in the week, has also been offering the clearing and settlement of cryptocurrency ETPs for hedge funds, as the adoption of crypto by institutions gathers pace.

Earlier this week the Financial Times reported that BNY Mellon has backed a new crypto trading platform called Pure Digital, following in the footsteps of its rival State Street. The move into crypto ETPs follows the relaunch of Goldman's cryptocurrency trading desk in March.

Bank of America has also approved the trading of bitcoin futures for some clients and is clearing cash-settled contracts, CoinDesk reported last week.

Read more:* *Bank of America Approves Bitcoin Futures Trading for Some Clients: Sources

Crypto ETPs are traded on an exchange, much like equities and ETFs, and track the performance of an underlying asset. Their popularity has been growing as they allow clients to invest in crypto without having to invest in the underlying digital assets themselves.

In June, ETC Group launched the first bitcoin ETP in the U.K. on the Aquis Exchange in London. There has also been an increasing number of cryptocurrency ETPs being listed on Switzerland's SIX Exchange and on Germany's Deutsche Boerse.

Almost half of family offices that do business with Goldman Sachs want exposure to cryptocurrencies, Bloomberg reported this week.

Goldman Sachs declined to comment.

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October 17, 2017

LabCFTC

A CFTC Primer on Virtual Currencies

COMMODITY FUTURES TRADING COMMISSION ★ 1975 ★

CFTC

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Contents

This primer format is intended to be an educational tool regarding emerging fintech innovations. It is not intended to describe the official policy or position of the CFTC, or to limit the CFTC's current or future positions or actions. The CFTC does not endorse the use or effectiveness of any of the financial products in this presentation. It is organized as follows:

OVERVIEW OF VIRTUAL CURRENCIES

What is a Virtual Currency?

- Although precise definitions offered by others are varied, an IRS definition provides us with a general idea:
  - "Virtual currency is a digital representation of value that functions as **a medium of exchange, a unit of account, and/or a store of value.**
  - In some environments, it operates like 'real' currency . . . but it **does not have legal tender status** [in the U.S.].
  - Virtual currency that has an equivalent value in real currency, or that acts as a substitute for real currency, is referred to as 'convertible' virtual currency. **Bitcoin is one example of a convertible virtual currency**.
  - Bitcoin can be digitally traded between users and can be purchased for, or exchanged into, U.S. dollars, Euros, and other real or virtual currencies."†

†IRS Notice 2014-21, available at https://www.irs.gov/businesses/small-businesses-self-employed/virtual-currencies (emphasis added). Please note that this definition is not a statement of the Commission's view, and is instead offered as an aid to enhance public understanding of virtual currencies. We further note that one prominent type of virtual currency is cryptocurrency. Cryptocurrency has been described as "an electronic payment system based on cryptographic proof instead of trust, allowing any two willing parties to transact directly with each other without the need for a trusted third party." Satoshi Nakamoto, Bitcoin: A Peer-to-Peer Electronic Cash System (Oct. 31, 2008), available at https://bitcoin.org/bitcoin.pdf.

What is Bitcoin?

- Bitcoin is currently the largest convertible virtual currency by market capitalization (close to $72 billion in August 2017)†
- Bitcoin was created in 2008 by a person or group that used the name "Satoshi Nakamoto," with the belief that:

  "[w]hat is needed is an electronic payment system based on cryptographic proof instead of trust, allowing any two willing parties to transact directly with each other without the need for a trusted third party."
- Bitcoin:
  - Is "pseudonymous" (or partially anonymous) in that an individual is identified by an alpha-numeric public key/address;
  - Relies on cryptography (and unique digital signatures) for security based on public and private keys and complex mathematical algorithms;
  - Runs on a decentralized peer-to-peer network of computers and "miners" that operate on open-source software and do "work" to validate and irrevocably log transactions on a permanent public distributed ledger visible to the entire network;
  - Solves the lack of trust between participants who may be strangers to each other on a public ledger through the transaction validation work noted in the sub-bullet above; and
  - Enables the transfer of ownership without the need for a trusted, central intermediary.

† Paul Vigna, *Bitcoin, Valued Like a Cool Blue Chip, Trading Like a Hot Small Cap*, Wall Street Journal (Aug. 29, 2017), available at https://blogs.wsj.com/moneybeat/2017/08/28/bitcoin-valued-like-a-blue-chip-trading-like-a-small-cap/. It is important to note that there are many other virtual currencies with sizeable market capitalizations that are built upon various Blockchain technologies, but may have different characteristics or functionalities than Bitcoin, including Ethereum (or Ether), Litecoin, and Ripple.

What is the Difference between Public and Private Ledger Systems?

- Certain virtual currencies operate on public distributed ledger systems that capture "blocks" of transactions – there is no inherent trust in this decentralized system.
  - Virtual currencies create an economic incentive for dispersed, independent, computers, or groups of computers, around the world to confirm transactions and perform verifiable "work" (that creates consensus) to publish a new block of transactions on the public ledger in exchange for a payment of the applicable virtual currency.
- Private / permissioned distributed ledger networks typically have some degree of trust between participants.
  - Private ledger systems allow a network of known participants to share transaction information between themselves more efficiently.
  - While cryptography and consensus may still be involved in private ledger systems, these systems do not necessarily involve a virtual currency that may serve as the economic incentive for miner or validator participation in public networks.

Sample Potential Use Cases of Virtual Currencies

- Store of Value
  - Like precious metals, many virtual currencies are a “non-yielding” asset (meaning they do not pay dividends or interest), but they may be more fungible, divisible, and portable
  - Limited or finite supply of virtual currencies may contrast with ‘real’ (fiat) currencies
- Trading
  - Trading in virtual currencies may result in capital gains or losses
  - Note that trading in virtual currencies may involve significant speculation and volatility risk (see Virtual Currency Risks section below)
- Payments and Transactions
  - Some merchants and online stores are accepting virtual currencies in exchange for physical and digital goods (i.e., payments)
  - Some public Blockchain systems rely on the payment of fees in virtual currency form in order to power the network and underlying transactions
- Transfer / Move Money
  - Domestic and international money transfer (e.g., remittances) in order to increase efficiencies and potentially reduce related fees

Sample Potential Use Cases of Blockchain/DLT Technology

Blockchain, or distributed ledger technology,* underpins many virtual currencies, but can also be used within private, permissioned ledger systems – versions of public and private systems may be used by:

- Financial Institutions
  - Trading & Payment Platforms / Clearing and Settlement
  - Regulatory Reporting, Compliance & Audit
  - Know Your Customer (KYC) / Anti-Money Laundering (AML)
  - Repurchase Agreement Transactions (“Repos,” i.e., short-term borrowing of securities)
- Governments
  - General Records Management
  - Title & Ownership Records Management (e.g., real property deeds and title transfer)
  - Regulatory Reporting and Oversight
- Cross-Industry
  - Smart Contracts (i.e., self executing agreements)
  - Resource / Asset Sharing Agreements (e.g., allowing rental of a personal car left behind during a vacation or allowing rental of excess computer or data storage)
  - Digital Identity (e.g., proof of identity when entering into a contract)

* *See generally* Marco Iansiti and Karim R. Lakhani, *The Truth About Blockchain*, Harvard Business Review (Jan-Feb 2017), available at https://hbr.org/2017/01/the-truth-about-blockchain (for a general overview of how a public Blockchain works).

THE ROLE OF THE CFTC

The CFTC's Mission

- The mission of the CFTC is to foster open, transparent, competitive, and financially sound markets. By working to avoid systemic risk, the Commission aims to protect market users and their funds, consumers, and the public from fraud, manipulation, and abusive practices related to derivatives and other products that are subject to the Commodity Exchange Act (CEA).
- To foster the public interest and fulfill its mission, the CFTC will act:
  - To deter and prevent price manipulation or any other disruptions to market integrity;
  - To ensure the financial integrity of all transactions subject to the CEA and the avoidance of systemic risk;
  - To protect all market participants from fraudulent or other abusive sales practices and misuse of customer assets; and
  - To promote responsible innovation and fair competition among boards of trade, other markets, and market participants.
- Responsible innovation is market-enhancing.

Virtual Currencies are Commodities

- The definition of “commodity” in the CEA is broad.
  - It can mean a physical commodity, such as an agricultural product (e.g., wheat, cotton) or natural resource (e.g., gold, oil).
  - It can mean a currency or interest rate.
  - The CEA definition of “commodity” also includes “all services, rights, and interests . . . in which contracts for future delivery are presently or in the future dealt in.”
- The CFTC first found that Bitcoin and other virtual currencies are properly defined as commodities in 2015.‡
- The CFTC has oversight over futures, options, and derivatives contracts.
- The CFTC’s jurisdiction is implicated when a virtual currency is used in a derivatives contract, or if there is fraud or manipulation involving a virtual currency traded in interstate commerce.
  - Beyond instances of fraud or manipulation, the CFTC generally does not oversee “spot” or cash market exchanges and transactions involving virtual currencies that do not utilize margin, leverage, or financing.

‡ See, In the Matter of: Coinflip, Inc., d/b/a Derivabit, and Francisco Riordan, CFTC Docket No. 15-29, available at http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfcoinfliprorder09172015.pdf.

Examples of Permitted Activities

- TeraExchange, LLC, a Swap Execution Facility ("SEF") registered with the CFTC, entered in to the virtual currency market in 2014 by listing a Bitcoin swap for trading. Trading on a SEF platform is limited to "eligible contract participants," a type of sophisticated trader, which includes various financial institutions and persons, with assets above specified statutory minimums.

- North American Derivatives Exchange Inc. ("NADEX"), a designated contract market ("DCM"), listed binary options based on the Tera Bitcoin Price Index from November 2014 to December 2016. Retail customers may trade on NADEX.

- LedgerX, LLC ("LedgerX") registered with the CFTC as a SEF and Derivative Clearing Organization ("DCO") in July 2017. It plans to list digital currency options.

Examples of Prohibited Activities‡

- Price manipulation of a virtual currency traded in interstate commerce.
- Pre-arranged or wash trading in an exchange-traded virtual currency swap or futures contract.
- A virtual currency futures or option contract or swap traded on a domestic platform or facility that has not registered with the CFTC as a SEF or DCM.
- Certain schemes involving virtual currency marketed to retail customers, such as off-exchange financed commodity transactions with persons who fail to register with the CFTC.

‡Please note that this is not an exhaustive list of prohibited activities.

ICOs, Virtual Tokens, and CFTC Oversight

- The Securities and Exchange Commission ("SEC") recently released a report about an Initial Coin Offering or "ICO" (the "DAO Report").‡
- The DAO Report explains that "The DAO" is an example of a "Decentralized Autonomous Organization," which is a "virtual" organization embodied in computer code and executed on a distributed ledger or blockchain.
- Investors exchanged Ether, a virtual currency, for virtual DAO "Tokens" to fund projects in which the investors would share in anticipated earnings. DAO Tokens could be resold on web-based platforms.
- Based on the facts and circumstances, the SEC determined that DAO Tokens are "securities" under the federal securities laws.
- There is no inconsistency between the SEC's analysis and the CFTC's determination that virtual currencies are commodities and that virtual tokens may be commodities or derivatives contracts depending on the particular facts and circumstances.
  - The CFTC looks beyond form and considers the actual substance and purpose of an activity when applying the federal commodities laws and CFTC regulations

‡ See Release No. 81207, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, available at https://www.sec.gov/litigation/investreport/34-81207.pdf.

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RISKS OF VIRTUAL CURRENCIES

Virtual Currencies Have Risks

- While virtual currencies have potential benefits, this emerging space also involves various risks, including:
  - Operational Risks
  - Cybersecurity Risks
  - Speculative Risks
  - Fraud and Manipulation Risks
- Virtual currencies are relatively unproven and may not perform as expected (for example, some have questioned whether public distributed ledgers are in fact immutable).
- Investors and users of virtual currencies should educate themselves about these and other risks before getting involved.

Virtual Currency: Operational Risk

- *Conduct extensive research before giving any money or personal information to a virtual currency platform.*

- The virtual currency marketplace is comprised of many different platforms where you can convert one type of virtual currency into another or into real currency, if offered.

- Many of these platforms are not subject to the supervision which applies to regulated exchanges. For example, if they engage in only certain spot or cash market transactions and do not utilize margin, leverage, or financing, they may be subject to federal and state money transmission and anti-money laundering laws, but they do not have to follow all the rules that regulated exchanges operate under.

- Some virtual currency platforms may be missing critical system safeguards and customer protection related systems; without adequate safeguards, customers may lose some or all of their virtual assets.

Virtual Currency: Cybersecurity Risk

- *Keep your property in safe accounts and carefully verify digital wallet addresses.*
- Some platforms may "commingle" (mix) customer assets in shared accounts (at a bank for real currency or a digital wallet for virtual currency). This may affect whether or how you can withdraw your currency.
- Depending on the structure and security of the digital wallet, some may be vulnerable to hacks, resulting in the theft of virtual currency or loss of customer assets.
  - If a bad actor gains access to your private key, it can take your virtual currency with limited or no recourse
- When transferring virtual currency, be sure to confirm the destination wallet address, even when using "copy and paste." It is possible for hackers to change digital wallet addresses on your computer.

Virtual Currency: Speculative Risk

- *Only invest what you are willing and able to lose.*
- The virtual currency marketplace has been subject to substantial volatility and price swings.
- An individual or coordinated group trading a large amount of virtual currency at once could affect the price, depending on the overall amount of trading in the marketplace.
- Periods of high volatility with inadequate trade volume may create adverse market conditions, leading to harmful effects such as customer orders being filled at undesirable prices.
- Some advertisements promise guaranteed returns – this can be a common tactic with fraudulent schemes.

Virtual Currency: Fraud & Manipulation Risk

- *Carefully research the platform you want to use, and pay close attention to the fee structure and systems safeguards.*

- Unregistered virtual currency platforms may not be able to adequately protect against market abuses by other traders.
  - For example, recent news articles discuss potential “spoofing” activity and other manipulative behavior that can negatively affect prices

- Some virtual currency platforms may be selling you virtual currency directly from their own account – these types of transactions may give the platform unfair advantages and sometimes resemble fraudulent “bucket shop” schemes.

- There is also a risk of Ponzi schemers and fraudsters seeking to capitalize on the current attention focused on virtual currencies.

UNITED STATES OF AMERICA
Before the
COMMODITY FUTURES TRADING COMMISSION

In the Matter of: **Coinflip, Inc., d/b/a Derivabit, and Francisco Riordan,** **Respondents.**	)	**CFTC Docket No. 15-29**

ORDER INSTITUTING PROCEEDINGS PURSUANT TO SECTIONS 6(c) AND 6(d) OF THE COMMODITY EXCHANGE ACT, MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS

I.

The Commodity Futures Trading Commission ("Commission") has reason to believe that from in or about March 2014 to at least August 2014 (the "Relevant Period"), Coinflip, Inc., d/b/a Derivabit ("Coinflip") and Francisco Riordan ("Riordan") (the "Respondents") violated Sections 4c(b) and 5h(a)(1) of the Commodity Exchange Act, as amended (the "Act"), 7 U.S.C. §§ 6c(b) and 7b-3(a)(1) (2012), and Commission Regulations 32.2 and 37.3(a)(1), 17 C.F.R. § 32.2 and 37.3(a)(1) (2014). Therefore, the Commission deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted to determine whether the Respondents engaged in the violations set forth herein and to determine whether any order should be issued imposing remedial sanctions.

II.

In anticipation of the institution of an administrative proceeding, the Respondents have submitted an Offer of Settlement ("Offer"), which the Commission has determined to accept. Without admitting or denying any of the findings or conclusions herein, Respondents consent to the entry of this Order Instituting Proceedings Pursuant to Sections 6(c) and 6(d) of the Commodity Exchange Act, Making Findings and Imposing Remedial Sanctions ("Order") and acknowledge service of this Order.[1]

[1] Respondents consent to the entry of this Order and to the use of these findings in this proceeding and in any other proceeding brought by the Commission or to which the Commission is a party; provided, however, that Respondents do not consent to the use of the Offer, or the findings or conclusions in the Order consented to in the Offer, as the sole basis for any other proceeding brought by the Commission, other than in a proceeding in bankruptcy or to enforce the terms of this Order. Nor do Respondents consent to the use of the Offer or the Order, or the findings or conclusions in this Order consented to in the Offer, by any other party in any other proceeding.

III.

The Commission finds the following:

A. Summary

During the Relevant Period, Respondents violated Sections 4c(b) and 5h(a)(1) of the Act and Commission Regulations 32.2 and 37.3(a)(1) by conducting activity related to commodity options contrary to Commission Regulations and by operating a facility for the trading or processing of swaps without being registered as a swap execution facility or designated contract market. Specifically, during the Relevant Period, Respondents operated an online facility named Derivabit, offering to connect buyers and sellers of Bitcoin option contracts.[2]

B. Respondents

Coinflip, Inc. is a Delaware corporation with a principal place of business in San Francisco, California. During the Relevant period, Coinflip operated Derivabit and its website derivabit.com. Coinflip has never been registered with the Commission.

Francisco Riordan is an individual residing in San Francisco, California. Riordan is a founder, the chief executive officer, and controlling person of Coinflip. Riordan has never been registered with the Commission.

C. Facts

Coinflip Conducted Activity Related to Illegal Commodity Options

Beginning in March 2014, Coinflip advertised Derivabit as a "risk management platform . . . that connects buyers and sellers of standardized Bitcoin options and futures contracts." During this period, Coinflip designated numerous put and call options contracts as eligible for trading on the Derivabit platform.[3] For these contracts, Coinflip listed Bitcoin as the asset underlying the option and denominated the strike and delivery prices in US Dollars. According to the derivabit.com website, a customer could place orders by registering as a user and depositing Bitcoin into an account in the user's name. Premiums and payments of settlement of the option contracts were to be paid using Bitcoin at a spot rate determined by a designated third-party Bitcoin currency exchange. Users had the ability to, and in fact did, post bids or offers for

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[2] Bitcoin is a "virtual currency," defined here as a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value, but does not have legal tender status in any jurisdiction. Bitcoin and other virtual currencies are distinct from "real" currencies, which are the coin and paper money of the United States or another country that are designated as legal tender, circulate, and are customarily used and accepted as a medium of exchange in the country of issuance.

[3] Although referenced it its solicitation materials, Coinflip did not offer any futures contracts during the Relevant Period.

the designated options contracts. Coinflip confirmed the bid or offer by communicating it to all users through its website.[4]

During the Relevant Period, Derivabit had approximately 400 users.

Riordan Controlled Coinflip and Directed Its Operations

Riordan was the founder, engineer and Chief Executive Officer of Coinflip. He exercised control over Coinflip's daily operations and possessed the power or ability to control all aspects of the Derivabit platform. Riordan participated in key aspects of Coinflip's illegal activity, including designing and implementing the Derivabit trading platform. Riordan's control enabled him to make design and substantive changes to Coinflip's operations, including the transition from offering Bitcoin options to OTC Bitcoin Forward Contracts. Ultimately, Riordan possessed the power and ability to direct Coinflip to cease operating the Derivabit platform.

LEGAL DISCUSSION

A. Virtual Currencies Such as Bitcoin are Commodities

Section 1a(9) of the Act defines "commodity" to include, among other things, "all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in." 7 U.S.C. § 1a(9). The definition of a "commodity" is broad. *See, e.g., Board of Trade of City of Chicago v. SEC*, 677 F. 2d 1137, 1142 (7th Cir. 1982). Bitcoin and other virtual currencies are encompassed in the definition and properly defined as commodities.

B. Coinflip Violated Sections 4c(b) Act and Commission Regulation 32.2

Section 4c(b) of the Act makes it unlawful for any person to "offer to enter into, enter into or confirm the execution of, any transaction involving any commodity . . . which is of the character of, or is commonly known to the trade as, an 'option' . . . , 'bid', 'offer', 'put', [or] 'call' . . . contrary to any rule, regulation, or order of the Commission prohibiting any such transaction." Section 1.3(hh) defines a "commodity option transaction" and "commodity option" to "mean any transaction or agreement in interstate commerce which is or is held out to be of the character of, or is commonly known to the trade as, an 'option,' 'privilege,' 'indemnity,' 'bid,' 'offer,' 'call,' 'put,' 'advance guaranty,' or 'decline guaranty,' and which is subject to regulation under the Act and these regulations." Section 32.2 of the Commission's Regulations, in turn,

[4] In July 2014, Coinflip began to offer what it characterized as "OTC Bitcoin Forward Contracts" for trading. Under this model, a Derivabit user would be matched through competitive bidding with a counterparty to execute a contract to exchange US Dollars for Bitcoins at a predetermined price and date. As part of its services, Coinflip would calculate and hold initial and maintenance margin payments and would also calculate and facilitate the transfer of final settlements at maturity or early termination. Coinflip advertised that the users could choose to institute an early termination at any time if its position was "in the money." Although the price would be expressed as an exchange rate between US Dollars and Bitcoins, Coinflip required all settlements and margin payments to be transacted in Bitcoins. No bids or offers were posted by Derivabit users for these contracts. Although these activities may have violated, or led to violations of, the Commodity Exchange Act, the Commission does not address this conduct here.

provides that it shall be unlawful for any person to "offer to enter into, enter into, confirm the execution of, maintain a position in, or otherwise conduct activity related to any transaction in interstate commerce that is a commodity option transaction unless: (a) [s]uch transaction is conducted in compliance with and subject to the provisions of the Act, including any Commission rule, regulation, or order thereunder, otherwise applicable to any other swap, or (b) [s]uch transaction is conducted pursuant to [Regulation] 32.3."

Between at least March 2014 and July 2014, Respondents conducted activity related to commodity option transactions, offered to enter into commodity option transactions and/or confirmed the existence of commodity option transactions. The options transactions were not conducted in compliance with Section 5h(a)(1) of the Act or Regulation 37.3(a)(1), a section of the Act and a Commission regulation otherwise applicable to swaps (*see infra* Section C) and were not conducted pursuant to Regulation 32.3.[5] Accordingly, Coinflip violated Section 4c(b) of the Act and Commission Regulation 32.2.

C. <u>Coinflip Violated Section 5h(a)(1) of the Act</u>

Section 5h(a)(1) of the Act forbids any person from operating "a facility for the trading or processing of swaps unless the facility is registered as a swap execution facility or as a designated contract market . . . ." 7 U.S.C. § 7b-3(a)(1). Section 1a(47) of the Act's definition of "swap" includes option contracts. 7 U.S.C. § 1a(47)(A)(i). Regulation 37.3(a)(1) similarly requires that any "person operating a facility that offers a trading system or platform in which more than one market participant has the ability to execute or trade swaps with more than one other market participant on the system or platform shall register the facility as a swap execution facility under this part or as a designated contract market under part 38 of this chapter." 17 C.F.R. § 37.3(a)(1) (2014).

During the Relevant Period, Coinflip operated a facility for the trading of swaps. However, Coinflip did not register the facility as a swap execution facility or designated contract market. Accordingly, Coinflip violated Section 5h(a)(1) of the Act and Regulation 37.3(a)(1).

D. <u>Riordan Is Liable for Coinflip's Violations as Its Controlling Person Under Section 13(b) of the Act</u>

Riordan controlled Coinflip, directly or indirectly, and did not act in good faith or knowingly induced, directly or indirectly, Coinflip's acts in violation of the Act and Regulations; therefore, pursuant to Section 13(b) of the Act, 7 U.S.C. § 13c(b) (2012), Riordan is liable for Coinflip's violations of Sections 4c(b) and 5h(a)(1) of the Act, 7 U.S.C. §§ 6c(b) and 7b-3(a)(1) (2012) and Regulations 32.2 and 37.3(a)(1), 17 C.F.R. §§ 32.2 and 37.3(a)(1) (2014).

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[5] To take advantage of the "trade option" exemptions set forth in Regulation 32.3, the offeror of the option must be an eligible contract participant as defined in Section 1a(18) of the Act or "producer, processor, or commercial user of, or a merchant handling the commodity," and have a reasonable basis to believe that the offeree was a "producer, processor, or commercial user of, or a merchant handling the commodity that is the subject of the commodity option transaction, or the products or by-products thereof, and such offeree is offered or entering into the commodity option transaction solely for purposes related to its business as such." 17 C.F.R. §§ 32.3(a)(1)(i)-(ii) and 32.3(a)(2).

IV.

FINDINGS OF VIOLATIONS

Based on the foregoing, the Commission finds that, during the Relevant Period, Respondents violated Sections 4c(b) and 5h(a)(1) of the Act, 7 U.S.C. §§ 4c(b) and 7b-3(a)(1) (2012), and Commission Regulations 32.2 and 37.3(a)(1), 17 C.F.R. §§ 32.2 and 37.3(a)(1) (2014).

V.

OFFER OF SETTLEMENT

Respondents have submitted an Offer in which they, without admitting or denying the findings and conclusions herein:

A. Acknowledge receipt of service of this Order;

B. Admit the jurisdiction of the Commission with respect to all matters set forth in this Order and for any action or proceeding brought or authorized by the Commission based on violation of or enforcement of this Order;

C. Waive:

1. the filing and service of a complaint and notice of hearing;
2. a hearing;
3. all post-hearing procedures;
4. judicial review by any court;
5. any and all objections to the participation by any member of the Commission's staff in the Commission's consideration of the Offer;
6. any and all claims that they may possess under the Equal Access to Justice Act, 5 U.S.C. § 504 (2012) and 28 U.S.C. § 2412 (2012), and/or the rules promulgated by the Commission in conformity therewith, Part 148 of the Commission's Regulations, 17 C.F.R. §§ 148.1-30 (2014), relating to, or arising from, this proceeding;
7. any and all claims that they may possess under the Small Business Regulatory Enforcement Fairness Act of 1996, Pub. L. No. 104-121, §§ 201-253, 110 Stat. 847, 857-868 (1996), as amended by Pub. L. No. 110-28, § 8302, 121 Stat. 112, 204-205 (2007), relating to, or arising from, this proceeding; and

8. any claims of Double Jeopardy based on the institution of this proceeding or the entry in this proceeding of any order imposing a civil monetary penalty or any other relief;

D. Stipulate that the record basis on which this Order is entered shall consist solely of the findings contained in this Order to which Respondents have consented in the Offer;

E. Consent, solely on the basis of the Offer, to the Commission's entry of this Order that:

1. makes findings by the Commission that Respondents violated Sections 4c(b) and 5h(a)(1) of the Act, 7 U.S.C. §§ 6c(b) and 7b-3(a)(1) (2012), and Commission Regulations 32.2 and 37.3(a)(1), 17 C.F.R. §§ 32.2 and 37.3(a)(1) (2014);

2. orders Respondents to cease and desist from violating Sections 4c(b) and 5h(a)(1) of the Act and Commission Regulations 32.2 and 37.3(a)(1); and

3. orders Respondents and their successors and assigns to comply with the conditions and undertakings consented to in the Offer and as set forth in Part VI of this Order.

Upon consideration, the Commission has determined to accept Respondents' Offer.

VI.

ORDER

Accordingly, IT IS HEREBY ORDERED THAT:

A. Respondents shall cease and desist from violating Sections 4c(b) and 5h(a)(1) of the Act, 7 U.S.C. §§ 6c(b) and 7b-3(a)(1) (2012), and Commission Regulations 32.2 and 37.3(a)(1), 17 C.F.R. §§ 32.2 and 37.3(a)(1) (2014).

B. Respondents and their successors and assigns shall comply with the following conditions and undertakings set forth in the Offer:

1. Public Statements: Respondents agree that neither they nor any of their successors and assigns, agents, or employees under their authority or control shall take any action or make any public statement denying, directly or indirectly, any findings or conclusions in the Order or creating, or tending to create, the impression that the Order is without a factual basis; provided, however, that nothing in this provision shall affect Respondents' (i) testimonial obligations; or (ii) right to take legal positions in other proceedings to which the Commission is not a party. Respondents and their successors and assigns shall undertake all steps necessary to ensure that all of their agents and/or employees under their authority or control understand and comply with this agreement.

2. Cooperation with the Commission: Respondents shall cooperate fully and expeditiously with the Commission, including the Commission's Division of

Enforcement, and any other governmental agency in this action, and in any investigation, civil litigation, or administrative matter related to the subject matter of this action or any current or future Commission investigation related thereto.

The provisions of this Order shall be effective as of this date.

By the Commission.

Christopher J. Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission

Dated: September 17, 2015

SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934

Release No. 81207 / July 25, 2017

Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO

I. Introduction and Summary

The United States Securities and Exchange Commission's ("Commission") Division of Enforcement ("Division") has investigated whether The DAO, an unincorporated organization; Slock.it UG ("Slock.it"), a German corporation; Slock.it's co-founders; and intermediaries may have violated the federal securities laws. The Commission has determined not to pursue an enforcement action in this matter based on the conduct and activities known to the Commission at this time.

As described more fully below, The DAO is one example of a Decentralized Autonomous Organization, which is a term used to describe a "virtual" organization embodied in computer code and executed on a distributed ledger or blockchain. The DAO was created by Slock.it and Slock.it's co-founders, with the objective of operating as a for-profit entity that would create and hold a corpus of assets through the sale of DAO Tokens to investors, which assets would then be used to fund "projects." The holders of DAO Tokens stood to share in the anticipated earnings from these projects as a return on their investment in DAO Tokens. In addition, DAO Token holders could monetize their investments in DAO Tokens by re-selling DAO Tokens on a number of web-based platforms ("Platforms") that supported secondary trading in the DAO Tokens.

After DAO Tokens were sold, but before The DAO was able to commence funding projects, an attacker used a flaw in The DAO's code to steal approximately one-third of The DAO's assets. Slock.it's co-founders and others responded by creating a work-around whereby DAO Token holders could opt to have their investment returned to them, as described in more detail below.

The investigation raised questions regarding the application of the U.S. federal securities laws to the offer and sale of DAO Tokens, including the threshold question whether DAO Tokens are securities. Based on the investigation, and under the facts presented, the Commission has determined that DAO Tokens are securities under the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act").[1] The Commission deems it appropriate and in the public interest to issue this report of investigation ("Report") pursuant to

[1] This Report does not analyze the question whether The DAO was an "investment company," as defined under Section 3(a) of the Investment Company Act of 1940 ("Investment Company Act"), in part, because The DAO never commenced its business operations funding projects. Those who would use virtual organizations should consider their obligations under the Investment Company Act.

Section 21(a) of the Exchange Act[2] to advise those who would use a Decentralized Autonomous Organization ("DAO Entity"), or other distributed ledger or blockchain-enabled means for capital raising, to take appropriate steps to ensure compliance with the U.S. federal securities laws. All securities offered and sold in the United States must be registered with the Commission or must qualify for an exemption from the registration requirements. In addition, any entity or person engaging in the activities of an exchange must register as a national securities exchange or operate pursuant to an exemption from such registration.

This Report reiterates these fundamental principles of the U.S. federal securities laws and describes their applicability to a new paradigm—virtual organizations or capital raising entities that use distributed ledger or blockchain technology to facilitate capital raising and/or investment and the related offer and sale of securities. The automation of certain functions through this technology, "smart contracts,"[3] or computer code, does not remove conduct from the purview of the U.S. federal securities laws.[4] This Report also serves to stress the obligation to comply with the registration provisions of the federal securities laws with respect to products and platforms involving emerging technologies and new investor interfaces.

II. Facts

A. <u>Background</u>

From April 30, 2016 through May 28, 2016, The DAO offered and sold approximately 1.15 billion DAO Tokens in exchange for a total of approximately 12 million Ether ("ETH"), a

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[2] Section 21(a) of the Exchange Act authorizes the Commission to investigate violations of the federal securities laws and, in its discretion, to "publish information concerning any such violations." This Report does not constitute an adjudication of any fact or issue addressed herein, nor does it make any findings of violations by any individual or entity. The facts discussed in Section II, *infra*, are matters of public record or based on documentary records. We are publishing this Report on the Commission's website to ensure that all market participants have concurrent and equal access to the information contained herein.

[3] Computer scientist Nick Szabo described a "smart contract" as:

> a computerized transaction protocol that executes terms of a contract. The general objectives of smart contract design are to satisfy common contractual conditions (such as payment terms, liens, confidentiality, and even enforcement), minimize exceptions both malicious and accidental, and minimize the need for trusted intermediaries. Related economic goals include lowering fraud loss, arbitrations and enforcement costs, and other transaction costs.

See Nick Szabo, *Smart Contracts*, 1994, http://www.virtualschool.edu/mon/Economics/SmartContracts.html.

[4] *See SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943) ("[T]he reach of the [Securities] Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as 'investment contracts,' or as 'any interest or instrument commonly known as a 'security'."); *see also Reves v. Ernst & Young*, 494 U.S. 56, 61 (1990) ("Congress' purpose in enacting the securities laws was to regulate investments, in whatever form they are made and by whatever name they are called.").

virtual currency[5] used on the Ethereum Blockchain.[6] As of the time the offering closed, the total ETH raised by The DAO was valued in U.S. Dollars ("USD") at approximately $150 million.

The concept of a DAO Entity is memorialized in a document (the "White Paper"), authored by Christoph Jentzsch, the Chief Technology Officer of Slock.it, a "Blockchain and IoT [(internet-of-things)] solution company," incorporated in Germany and co-founded by Christoph Jentzsch, Simon Jentzsch (Christoph Jentzsch's brother), and Stephan Tual ("Tual").[7] The White Paper purports to describe "the first implementation of a [DAO Entity] code to automate organizational governance and decision making."[8] The White Paper posits that a DAO Entity "can be used by individuals working together collaboratively outside of a traditional corporate form. It can also be used by a registered corporate entity to automate formal governance rules contained in corporate bylaws or imposed by law." The White Paper proposes an entity—a DAO Entity—that would use smart contracts to attempt to solve governance issues it described as inherent in traditional corporations.[9] As described, a DAO Entity purportedly would supplant traditional mechanisms of corporate governance and management with a blockchain such that contractual terms are "formalized, automated and enforced using software."[10]

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[5] The Financial Action Task Force defines "virtual currency" as:

> a digital representation of value that can be digitally traded and functions as: (1) a medium of exchange; and/or (2) a unit of account; and/or (3) a store of value, but does not have legal tender status (i.e., when tendered to a creditor, is a valid and legal offer of payment) in any jurisdiction. It is not issued or guaranteed by any jurisdiction, and fulfils the above functions only by agreement within the community of users of the virtual currency. Virtual currency is distinguished from fiat currency (a.k.a. "real currency," "real money," or "national currency"), which is the coin and paper money of a country that is designated as its legal tender; circulates; and is customarily used and accepted as a medium of exchange in the issuing country. It is distinct from e-money, which is a digital representation of fiat currency used to electronically transfer value denominated in fiat currency.

FATF Report, Virtual Currencies, Key Definitions and Potential AML/CFT Risks, FINANCIAL ACTION TASK FORCE (June 2014), http://www.fatf-gafi.org/media/fatf/documents/reports/Virtual-currency-key-definitions-and-potential-aml-cft-risks.pdf.

[6] Ethereum, developed by the Ethereum Foundation, a Swiss nonprofit organization, is a decentralized platform that runs smart contracts on a blockchain known as the Ethereum Blockchain.

[7] Christoph Jentzsch released the final draft of the White Paper on or around March 23, 2016. He introduced his concept of a DAO Entity as early as November 2015 at an Ethereum Developer Conference in London, as a medium to raise funds for Slock.it, a German start-up he co-founded in September 2015. Slock.it purports to create technology that embeds smart contracts that run on the Ethereum Blockchain into real-world devices and, as a result, for example, permits anyone to rent, sell or share physical objects in a decentralized way. *See* SLOCK.IT, https://slock.it/.

[8] Christoph Jentzsch, *Decentralized Autonomous Organization to Automate Governance Final Draft – Under Review*, https://download.slock.it/public/DAO/WhitePaper.pdf.

[9] *Id.*

[10] *Id.* The White Paper contained the following statement:

> A word of caution, at the outset: the legal status of [DAO Entities] remains the subject of active and vigorous debate and discussion. Not everyone shares the same definition. Some have said that [DAO Entities] are autonomous code and can operate independently of legal systems; others

B. The DAO

"The DAO" is the "first generation" implementation of the White Paper concept of a DAO Entity, and it began as an effort to create a "crowdfunding contract" to raise "funds to grow [a] company in the crypto space."[11] In November 2015, at an Ethereum Developer Conference in London, Christoph Jentzsch described his proposal for The DAO as a "for-profit DAO [Entity]," where participants would send ETH (a virtual currency) to The DAO to purchase DAO Tokens, which would permit the participant to vote and entitle the participant to "rewards."[12] Christoph Jentzsch likened this to "buying shares in a company and getting … dividends."[13] The DAO was to be "decentralized" in that it would allow for voting by investors holding DAO Tokens.[14] All funds raised were to be held at an Ethereum Blockchain "address" associated with The DAO and DAO Token holders were to vote on contract proposals, including proposals to The DAO to fund projects and distribute The DAO's anticipated earnings from the projects it funded.[15] The DAO was intended to be "autonomous" in that project proposals were in the form of smart contracts that exist on the Ethereum Blockchain and the votes were administered by the code of The DAO.[16]

> have said that [DAO Entities] must be owned or operate[d] by humans or human created entities. There will be many use cases, and the DAO [Entity] code will develop over time. Ultimately, how a DAO [Entity] functions and its legal status will depend on many factors, including how DAO [Entity] code is used, where it is used, and who uses it. This paper does not speculate about the legal status of [DAO Entities] worldwide. This paper is not intended to offer legal advice or conclusions. Anyone who uses DAO [Entity] code will do so at their own risk.

Id.

[11] Christoph Jentzsch, *The History of the DAO and Lessons Learned*, SLOCK.IT BLOG (Aug. 24, 2016), https://blog.slock.it/the-history-of-the-dao-and-lessons-learned-d06740f8cfa5#.5o62zo8uv. Although The DAO has been described as a "crowdfunding contract," The DAO would not have met the requirements of Regulation Crowdfunding, adopted under Title III of the Jumpstart Our Business Startups (JOBS) Act of 2012 (providing an exemption from registration for certain crowdfunding), because, among other things, it was not a broker-dealer or a funding portal registered with the SEC and the Financial Industry Regulatory Authority ("FINRA"). *See Regulation Crowdfunding: A Small Entity Compliance Guide for Issuers*, SEC (Apr. 5, 2017), https://www.sec.gov/info/smallbus/secg/rccomplianceguide-051316.htm; *Updated Investor Bulletin: Crowdfunding for Investors*, SEC (May 10, 2017), https://www.sec.gov/oiea/investor-alerts-bulletins/ib_crowdfunding-.html.

[12] *See* Slockit, *Slock.it DAO demo at Devcon1: IoT + Blockchain*, YOUTUBE (Nov. 13, 2015), https://www.youtube.com/watch?v=49wHQoJxYPo.

[13] *Id.*

[14] *See* Jentzsch, *supra* note 8.

[15] *Id.* In theory, there was no limitation on the type of project that could be proposed. For example, proposed "projects" could include, among other things, projects that would culminate in the creation of products or services that DAO Token holders could use or charge others for using.

[16] *Id.*

On or about April 29, 2016, Slock.it deployed The DAO code on the Ethereum Blockchain, as a set of pre-programmed instructions.[17] This code was to govern how The DAO was to operate.

To promote The DAO, Slock.it's co-founders launched a website ("The DAO Website"). The DAO Website included a description of The DAO's intended purpose: "To blaze a new path in business for the betterment of its members, existing simultaneously nowhere and everywhere and operating solely with the steadfast iron will of unstoppable code."[18] The DAO Website also described how The DAO operated, and included a link through which DAO Tokens could be purchased. The DAO Website also included a link to the White Paper, which provided detailed information about a DAO Entity's structure and its source code and, together with The DAO Website, served as the primary source of promotional materials for The DAO. On The DAO Website and elsewhere, Slock.it represented that The DAO's source code had been reviewed by "one of the world's leading security audit companies" and "no stone was left unturned during those five whole days of security analysis."[19]

Slock.it's co-founders also promoted The DAO by soliciting media attention and by posting almost daily updates on The DAO's status on The DAO and Slock.it websites and numerous online forums relating to blockchain technology. Slock.it's co-founders used these posts to communicate to the public information about how to participate in The DAO, including: how to create and acquire DAO Tokens; the framework for submitting proposals for projects; and how to vote on proposals. Slock.it also created an online forum on The DAO Website, as well as administered "The DAO Slack" channel, an online messaging platform in which over 5,000 invited "team members" could discuss and exchange ideas about The DAO in real time.

1. DAO Tokens

In exchange for ETH, The DAO created DAO Tokens (proportional to the amount of ETH paid) that were then assigned to the Ethereum Blockchain address of the person or entity remitting the ETH. A DAO Token granted the DAO Token holder certain voting and ownership rights. According to promotional materials, The DAO would earn profits by funding projects

[17] According to the White Paper, a DAO Entity is "activated by deployment on the Ethereum [B]lockchain. Once deployed, a [DAO Entity's] code requires 'ether' [ETH] to engage in transactions on Ethereum. Ether is the digital fuel that powers the Ethereum Network." The only way to update or alter The DAO's code is to submit a new proposal for voting and achieve a majority consensus on that proposal. *See* Jentzsch, *supra* note 8. According to Slock.it's website, Slock.it gave The DAO code to the Ethereum community, noting that:

> The DAO framework is [a] side project of Slock.it UG and a gift to the Ethereum community. It consisted of a definitive whitepaper, smart contract code audited by one of the best security companies in the world and soon, a complete frontend interface. All free and open source for anyone to re-use, it is our way to say 'thank you' to the community.

SLOCK.IT, https://slock.it. The DAO code is publicly-available on GitHub, a host of source code. *See The Standard DAO Framework, Inc., Whitepaper*, GITHUB, https://github.com/slockit/DAO.

[18] The DAO Website was available at https://daohub.org.

[19] Stephen Tual, *Deja Vu DAO Smart Contracts Audit Results*, SLOCK.IT BLOG (Apr. 5, 2016), https://blog.slock.it/deja-vu-dai-smart-contracts-audit-results-d26bc088e32e.

that would provide DAO Token holders a return on investment. The various promotional materials disseminated by Slock.it's co-founders touted that DAO Token holders would receive "rewards," which the White Paper defined as, "any [ETH] received by a DAO [Entity] generated from projects the DAO [Entity] funded." DAO Token holders would then vote to either use the rewards to fund new projects or to distribute the ETH to DAO Token holders.

From April 30, 2016 through May 28, 2016 (the "Offering Period"), The DAO offered and sold DAO Tokens. Investments in The DAO were made "pseudonymously" (i.e., an individual's or entity's pseudonym was their Ethereum Blockchain address). To purchase a DAO Token offered for sale by The DAO, an individual or entity sent ETH from their Ethereum Blockchain address to an Ethereum Blockchain address associated with The DAO. All of the ETH raised in the offering as well as any future profits earned by The DAO were to be pooled and held in The DAO's Ethereum Blockchain address. The token price fluctuated in a range of approximately 1 to 1.5 ETH per 100 DAO Tokens, depending on when the tokens were purchased during the Offering Period. Anyone was eligible to purchase DAO Tokens (as long as they paid ETH). There were no limitations placed on the number of DAO Tokens offered for sale, the number of purchasers of DAO Tokens, or the level of sophistication of such purchasers.

DAO Token holders were not restricted from re-selling DAO Tokens acquired in the offering, and DAO Token holders could sell their DAO Tokens in a variety of ways in the secondary market and thereby monetize their investment as discussed below. Prior to the Offering Period, Slock.it solicited at least one U.S. web-based platform to trade DAO Tokens on its system and, at the time of the offering, The DAO Website and other promotional materials disseminated by Slock.it included representations that DAO Tokens would be available for secondary market trading after the Offering Period via several platforms. During the Offering Period and afterwards, the Platforms posted notices on their own websites and on social media that each planned to support secondary market trading of DAO Tokens.[20]

In addition to secondary market trading on the Platforms, after the Offering Period, DAO Tokens were to be freely transferable on the Ethereum Blockchain. DAO Token holders would also be permitted to redeem their DAO Tokens for ETH through a complicated, multi-week (approximately 46-day) process referred to as a DAO Entity "split."[21]

2. Participants in The DAO

According to the White Paper, in order for a project to be considered for funding with "a DAO [Entity]'s [ETH]," a "Contractor" first must submit a proposal to the DAO Entity. Specifically, DAO Token holders expected Contractors to submit proposals for projects that could provide DAO Token holders returns on their investments. Submitting a proposal to The DAO involved: (1) writing a smart contract, and then deploying and publishing it on the

[20] The Platforms are registered with FinCEN as "Money Services Businesses" and provide systems whereby customers may exchange virtual currencies for other virtual currencies or fiat currencies.

[21] According to the White Paper, the primary purpose of a split is to protect minority shareholders and prevent what is commonly referred to as a "51% Attack," whereby an attacker holding 51% of a DAO Entity's Tokens could create a proposal to send all of the DAO Entity's funds to himself or herself.

Ethereum Blockchain; and (2) posting details about the proposal on The DAO Website, including the Ethereum Blockchain address of the deployed contract and a link to its source code. Proposals could be viewed on The DAO Website as well as other publicly-accessible websites. Per the White Paper, there were two prerequisites for submitting a proposal. An individual or entity must: (1) own at least one DAO Token; and (2) pay a deposit in the form of ETH that would be forfeited to the DAO Entity if the proposal was put up for a vote and failed to achieve a quorum of DAO Token holders. It was publicized that Slock.it would be the first to submit a proposal for funding.[22]

ETH raised by The DAO was to be distributed to a Contractor to fund a proposal only on a majority vote of DAO Token holders.[23] DAO Token holders were to cast votes, which would be weighted by the number of tokens they controlled, for or against the funding of a specific proposal. The voting process, however, was publicly criticized in that it could incentivize distorted voting behavior and, as a result, would not accurately reflect the consensus of the majority of DAO Token holders. Specifically, as noted in a May 27, 2016 blog post by a group of computer security researchers, The DAO's structure included a "strong positive bias to vote YES on proposals and to suppress NO votes as a side effect of the way in which it restricts users' range of options following the casting of a vote."[24]

Before any proposal was put to a vote by DAO Token holders, it was required to be reviewed by one or more of The DAO's "Curators." At the time of the formation of The DAO, the Curators were a group of individuals chosen by Slock.it.[25] According to the White Paper, the Curators of a DAO Entity had "considerable power." The Curators performed crucial security functions and maintained ultimate control over which proposals could be submitted to, voted on, and funded by The DAO. As stated on The DAO Website during the Offering Period, The DAO relied on its Curators for "failsafe protection" and for protecting The DAO from "malicous [sic] actors." Specifically, per The DAO Website, a Curator was responsible for: (1) confirming that any proposal for funding originated from an identifiable person or organization; and (2)

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[22] It was stated on The DAO Website and elsewhere that Slock.it anticipated that it would be the first to submit a proposal for funding. In fact, a draft of Slock.it's proposal for funding for an "Ethereum Computer and Universal Sharing Network" was publicly-available online during the Offering Period.

[23] DAO Token holders could vote on proposals, either by direct interaction with the Ethereum Blockchain or by using an application that interfaces with the Ethereum Blockchain. It was generally acknowledged that DAO Token holders needed some technical knowledge in order to submit a vote, and The DAO Website included a link to a step-by-step tutorial describing how to vote on proposals.

[24] By voting on a proposal, DAO Token holders would "tie up" their tokens until the end of the voting cycle. *See* Jentzsch, *supra* note 8 at 8 ("The tokens used to vote will be blocked, meaning they can not [sic] be transferred until the proposal is closed."). If, however, a DAO Token holder abstained from voting, the DAO Token holder could avoid these restrictions; any DAO Tokens not submitted for a vote could be withdrawn or transferred at any time. As a result, DAO Token holders were incentivized either to vote yes or to abstain from voting. *See* Dino Mark et al., *A Call for a Temporary Moratorium on The DAO*, HACKING, DISTRIBUTED (May 27, 2016, 1:35 PM), http://hackingdistributed.com/2016/05/27/dao-call-for-moratorium/.

[25] At the time of The DAO's launch, The DAO Website identified eleven "high profile" individuals as holders of The DAO's Curator "Multisig" (or "private key"). These individuals all appear to live outside of the United States. Many of them were associated with the Ethereum Foundation, and The DAO Website touted the qualifications and trustworthiness of these individuals.

confirming that smart contracts associated with any such proposal properly reflected the code the Contractor claims to have deployed on the Ethereum Blockchain. If a Curator determined that the proposal met these criteria, the Curator could add the proposal to the "whitelist," which was a list of Ethereum Blockchain addresses that could receive ETH from The DAO if the majority of DAO Token holders voted for the proposal.

Curators of The DAO had ultimate discretion as to whether or not to submit a proposal for voting by DAO Token holders. Curators also determined the order and frequency of proposals, and could impose subjective criteria for whether the proposal should be whitelisted. One member of the group chosen by Slock.it to serve collectively as the Curator stated publicly that the Curator had "complete control over the whitelist … the order in which things get whitelisted, the duration for which [proposals] get whitelisted, when things get unwhitelisted … [and] clear ability to control the order and frequency of proposals," noting that "curators have tremendous power."[26] Another Curator publicly announced his subjective criteria for determining whether to whitelist a proposal, which included his personal ethics.[27] Per the White Paper, a Curator also had the power to reduce the voting quorum requirement by 50% every other week. Absent action by a Curator, the quorum could be reduced by 50% only if no proposal had reached the required quorum for 52 weeks.

3. Secondary Market Trading on the Platforms

During the period from May 28, 2016 through early September 2016, the Platforms became the preferred vehicle for DAO Token holders to buy and sell DAO Tokens in the secondary market using virtual or fiat currencies. Specifically, the Platforms used electronic systems that allowed their respective customers to post orders for DAO Tokens on an anonymous basis. For example, customers of each Platform could buy or sell DAO Tokens by entering a market order on the Platform's system, which would then match with orders from other customers residing on the system. Each Platform's system would automatically execute these orders based on pre-programmed order interaction protocols established by the Platform.

None of the Platforms received orders for DAO Tokens from non-Platform customers or routed its respective customers' orders to any other trading destinations. The Platforms publicly displayed all their quotes, trades, and daily trading volume in DAO Tokens on their respective websites. During the period from May 28, 2016 through September 6, 2016, one such Platform executed more than 557,378 buy and sell transactions in DAO Tokens by more than 15,000 of its U.S. and foreign customers. During the period from May 28, 2016 through August 1, 2016, another such Platform executed more than 22,207 buy and sell transactions in DAO Tokens by more than 700 of its U.S. customers.

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[26] Epicenter, *EB134 – Emin Gün Sirer And Vlad Zamfir: On A Rocky DAO*, YOUTUBE (June 6, 2016), https://www.youtube.com/watch?v=ON5GhIQdFU8.

[27] Andrew Quentson, *Are the DAO Curators Masters or Janitors?*, THE COIN TELEGRAPH (June 12, 2016), https://cointelegraph.com/news/are-the-dao-curators-masters-or-janitors.

4. *Security Concerns, The "Attack" on The DAO, and The Hard Fork*

In late May 2016, just prior to the expiration of the Offering Period, concerns about the safety and security of The DAO's funds began to surface due to vulnerabilities in The DAO's code. On May 26, 2016, in response to these concerns, Slock.it submitted a "DAO Security Proposal" that called for the development of certain updates to The DAO's code and the appointment of a security expert.[28] Further, on June 3, 2016, Christoph Jentzsch, on behalf of Slock.it, proposed a moratorium on all proposals until alterations to The DAO's code to fix vulnerabilities in The DAO's code had been implemented.[29]

On June 17, 2016, an unknown individual or group (the "Attacker") began rapidly diverting ETH from The DAO, causing approximately 3.6 million ETH—1/3 of the total ETH raised by The DAO offering—to move from The DAO's Ethereum Blockchain address to an Ethereum Blockchain address controlled by the Attacker (the "Attack").[30] Although the diverted ETH was then held in an address controlled by the Attacker, the Attacker was prevented by The DAO's code from moving the ETH from that address for 27 days.[31]

In order to secure the diverted ETH and return it to DAO Token holders, Slock.it's co-founders and others endorsed a "Hard Fork" to the Ethereum Blockchain. The "Hard Fork," called for a change in the Ethereum protocol on a going forward basis that would restore the DAO Token holders' investments as if the Attack had not occurred. On July 20, 2016, after a majority of the Ethereum network adopted the necessary software updates, the new, forked Ethereum Blockchain became active.[32] The Hard Fork had the effect of transferring all of the funds raised (including those held by the Attacker) from The DAO to a recovery address, where DAO Token holders could exchange their DAO Tokens for ETH.[33] All DAO Token holders

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[28] *See* Stephan Tual, *Proposal #1-DAO Security, Redux,* SLOCK.IT BLOG (May 26, 2016), https://blog.slock.it/both-our-proposals-are-now-out-voting-starts-saturday-morning-ba322d6d3aea. The unnamed security expert would "act as the first point of contact for security disclosures, and continually monitor, pre-empt and avert any potential attack vectors The DAO may face, including social, technical and economic attacks." *Id.* Slock.it initially proposed a much broader security proposal that included the formation of a "DAO Security" group, the establishment of a "Bug Bounty Program," and routine external audits of The DAO's code. However, the cost of the proposal (125,000 ETH), which would be paid from The DAO's funds, was immediately criticized as too high and Slock.it decided instead to submit the revised proposal described above. *See* Stephan Tual, *DAO.Security, a Proposal to guarantee the integrity of The DAO,* SLOCK.IT BLOG (May 25, 2016), https://blog.slock.it/dao-security-a-proposal-to-guarantee-the-integrity-of-the-dao-3473899ace9d.

[29] *See TheDAO Proposal_ID 5*, ETHERSCAN, https://etherscan.io/token/thedao-proposal/5.

[30] *See* Stephan Tual, *DAO Security Advisory: live updates*, SLOCK.IT BLOG (June 17, 2016), https://blog.slock.it/dao-security-advisory-live-updates-2a0a42a2d07b.

[31] *Id.*

[32] A minority group, however, elected not to adopt the new Ethereum Blockchain created by the Hard Fork because to do so would run counter to the concept that a blockchain is immutable. Instead they continued to use the former version of the blockchain, which is now known as "Ethereum Classic."

[33] *See* Christoph Jentzsch, *What the 'Fork' Really Means,* SLOCK.IT BLOG (July 18, 2016), https://blog.slock.it/what-the-fork-really-means-6fe573ac31dd.

who adopted the Hard Fork could exchange their DAO Tokens for ETH, and avoid any loss of the ETH they had invested.[34]

III. Discussion

The Commission is aware that virtual organizations and associated individuals and entities increasingly are using distributed ledger technology to offer and sell instruments such as DAO Tokens to raise capital. These offers and sales have been referred to, among other things, as "Initial Coin Offerings" or "Token Sales." Accordingly, the Commission deems it appropriate and in the public interest to issue this Report in order to stress that the U.S. federal securities law may apply to various activities, including distributed ledger technology, depending on the particular facts and circumstances, without regard to the form of the organization or technology used to effectuate a particular offer or sale. In this Report, the Commission considers the particular facts and circumstances of the offer and sale of DAO Tokens to demonstrate the application of existing U.S. federal securities laws to this new paradigm.

A. Section 5 of the Securities Act

The registration provisions of the Securities Act contemplate that the offer or sale of securities to the public must be accompanied by the "full and fair disclosure" afforded by registration with the Commission and delivery of a statutory prospectus containing information necessary to enable prospective purchasers to make an informed investment decision. Registration entails disclosure of detailed "information about the issuer's financial condition, the identity and background of management, and the price and amount of securities to be offered … ." *SEC v. Cavanagh*, 1 F. Supp. 2d 337, 360 (S.D.N.Y. 1998), *aff'd*, 155 F.3d 129 (2d Cir. 1998). "The registration statement is designed to assure public access to material facts bearing on the value of publicly traded securities and is central to the Act's comprehensive scheme for protecting public investors." *SEC v. Aaron*, 605 F.2d 612, 618 (2d Cir. 1979) (citing *SEC v. Ralston Purina Co.*, 346 U.S. 119, 124 (1953)), *vacated on other grounds*, 446 U.S. 680 (1980). Section 5(a) of the Securities Act provides that, unless a registration statement is in effect as to a security, it is unlawful for any person, directly or indirectly, to engage in the offer or sale of securities in interstate commerce. Section 5(c) of the Securities Act provides a similar prohibition against offers to sell, or offers to buy, unless a registration statement has been filed. Thus, both Sections 5(a) and 5(c) of the Securities Act prohibit the unregistered offer or sale of securities in interstate commerce. 15 U.S.C. § 77e(a) and (c). Violations of Section 5 do not require scienter. *SEC v. Universal Major Indus. Corp.*, 546 F.2d 1044, 1047 (2d Cir. 1976).

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[34] *Id.*

B. DAO Tokens Are Securities

1. Foundational Principles of the Securities Laws Apply to Virtual Organizations or Capital Raising Entities Making Use of Distributed Ledger Technology

Under Section 2(a)(1) of the Securities Act and Section 3(a)(10) of the Exchange Act, a security includes "an investment contract." *See* 15 U.S.C. §§ 77b-77c. An investment contract is an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others. *See SEC v. Edwards,* 540 U.S. 389, 393 (2004); *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946); *see also United Housing Found., Inc. v. Forman*, 421 U.S. 837, 852-53 (1975) (The "touchstone" of an investment contract "is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others."). This definition embodies a "*flexible rather than a static principle*, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." *Howey*, 328 U.S. at 299 (emphasis added). The test "permits the fulfillment of the statutory purpose of compelling full and fair disclosure relative to the issuance of 'the many types of instruments that in our commercial world fall within the ordinary concept of a security.'" *Id.* In analyzing whether something is a security, "form should be disregarded for substance," *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967), "and the emphasis should be on economic realities underlying a transaction, and not on the name appended thereto." *United Housing Found.*, 421 U.S. at 849.

2. Investors in The DAO Invested Money

In determining whether an investment contract exists, the investment of "money" need not take the form of cash. *See, e.g., Uselton v. Comm. Lovelace Motor Freight, Inc.*, 940 F.2d 564, 574 (10th Cir. 1991) ("[I]n spite of *Howey's* reference to an 'investment of money,' it is well established that cash is not the only form of contribution or investment that will create an investment contract.").

Investors in The DAO used ETH to make their investments, and DAO Tokens were received in exchange for ETH. Such investment is the type of contribution of value that can create an investment contract under *Howey*. *See SEC v. Shavers*, No. 4:13-CV-416, 2014 WL 4652121, at *1 (E.D. Tex. Sept. 18, 2014) (holding that an investment of Bitcoin, a virtual currency, meets the first prong of *Howey*); *Uselton*, 940 F.2d at 574 ("[T]he 'investment' may take the form of 'goods and services,' or some other 'exchange of value'.") (citations omitted).

3. With a Reasonable Expectation of Profits

Investors who purchased DAO Tokens were investing in a common enterprise and reasonably expected to earn profits through that enterprise when they sent ETH to The DAO's Ethereum Blockchain address in exchange for DAO Tokens. "[P]rofits" include "dividends, other periodic payments, or the increased value of the investment." *Edwards*, 540 U.S. at 394. As described above, the various promotional materials disseminated by Slock.it and its co-founders informed investors that The DAO was a for-profit entity whose objective was to fund projects in exchange for a return on investment.[35] The ETH was pooled and available to The DAO to fund projects. The projects (or "contracts") would be proposed by Contractors. If the proposed contracts were whitelisted by Curators, DAO Token holders could vote on whether The DAO should fund the proposed contracts. Depending on the terms of each particular contract, DAO Token holders stood to share in potential profits from the contracts. Thus, a reasonable investor would have been motivated, at least in part, by the prospect of profits on their investment of ETH in The DAO.

4. *Derived from the Managerial Efforts of Others*

a. The Efforts of Slock.it, Slock.it's Co-Founders, and The DAO's Curators Were Essential to the Enterprise

Investors' profits were to be derived from the managerial efforts of others—specifically, Slock.it and its co-founders, and The DAO's Curators. The central issue is "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise." *SEC v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476, 482 (9th Cir. 1973). The DAO's investors relied on the managerial and entrepreneurial efforts of Slock.it and its co-founders, and The DAO's Curators, to manage The DAO and put forth project proposals that could generate profits for The DAO's investors.

Investors' expectations were primed by the marketing of The DAO and active engagement between Slock.it and its co-founders with The DAO and DAO Token holders. To market The DAO and DAO Tokens, Slock.it created The DAO Website on which it published the White Paper explaining how a DAO Entity would work and describing their vision for a DAO Entity. Slock.it also created and maintained other online forums that it used to provide information to DAO Token holders about how to vote and perform other tasks related to their investment. Slock.it appears to have closely monitored these forums, answering questions from DAO Token holders about a variety of topics, including the future of The DAO, security concerns, ground rules for how The DAO would work, and the anticipated role of DAO Token holders. The creators of The DAO held themselves out to investors as experts in Ethereum, the blockchain protocol on which The DAO operated, and told investors that they had selected persons to serve as Curators based on their expertise and credentials. Additionally, Slock.it told investors that it expected to put forth the first substantive profit-making contract proposal—a blockchain venture in its area of expertise. Through their conduct and marketing materials, Slock.it and its co-founders led investors to believe that they could be relied on to provide the significant managerial efforts required to make The DAO a success.

Investors in The DAO reasonably expected Slock.it and its co-founders, and The DAO's Curators, to provide significant managerial efforts after The DAO's launch. The expertise of The DAO's creators and Curators was critical in monitoring the operation of The DAO, safeguarding investor funds, and determining whether proposed contracts should be put for a

[35] That the "projects" could encompass services and the creation of goods for use by DAO Token holders does not change the core analysis that investors purchased DAO Tokens with the expectation of earning profits from the efforts of others.

vote. Investors had little choice but to rely on their expertise. At the time of the offering, The DAO's protocols had already been pre-determined by Slock.it and its co-founders, including the control that could be exercised by the Curators. Slock.it and its co-founders chose the Curators, whose function it was to: (1) vet Contractors; (2) determine whether and when to submit proposals for votes; (3) determine the order and frequency of proposals that were submitted for a vote; and (4) determine whether to halve the default quorum necessary for a successful vote on certain proposals. Thus, the Curators exercised significant control over the order and frequency of proposals, and could impose their own subjective criteria for whether the proposal should be whitelisted for a vote by DAO Token holders. DAO Token holders' votes were limited to proposals whitelisted by the Curators, and, although any DAO Token holder could put forth a proposal, each proposal would follow the same protocol, which included vetting and control by the current Curators. While DAO Token holders could put forth proposals to replace a Curator, such proposals were subject to control by the current Curators, including whitelisting and approval of the new address to which the tokens would be directed for such a proposal. In essence, Curators had the power to determine whether a proposal to remove a Curator was put to a vote.[36]

And, Slock.it and its co-founders did, in fact, actively oversee The DAO. They monitored The DAO closely and addressed issues as they arose, proposing a moratorium on all proposals until vulnerabilities in The DAO's code had been addressed and a security expert to monitor potential attacks on The DAO had been appointed. When the Attacker exploited a weakness in the code and removed investor funds, Slock.it and its co-founders stepped in to help resolve the situation.

b. DAO Token Holders' Voting Rights Were Limited

Although DAO Token holders were afforded voting rights, these voting rights were limited. DAO Token holders were substantially reliant on the managerial efforts of Slock.it, its co-founders, and the Curators.[37] Even if an investor's efforts help to make an enterprise profitable, those efforts do not necessarily equate with a promoter's significant managerial efforts or control over the enterprise. *See, e.g.*, *Glenn W. Turner*, 474 F.2d at 482 (finding that a multi-level marketing scheme was an investment contract and that investors relied on the promoter's managerial efforts, despite the fact that investors put forth the majority of the labor that made the enterprise profitable, because the promoter dictated the terms and controlled the scheme itself); *Long v. Shultz*, 881 F.2d 129, 137 (5th Cir. 1989) ("An investor may authorize the assumption of particular risks that would create the possibility of greater profits or losses but still depend on a third party for all of the essential managerial efforts without which the risk could not

[36] DAO Token holders could put forth a proposal to split from The DAO, which would result in the creation of a new DAO Entity with a new Curator. Other DAO Token holders would be allowed to join the new DAO Entity as long as they voted yes to the original "split" proposal. Unlike all other contract proposals, a proposal to split did not require a deposit or a quorum, and it required a seven-day debating period instead of the minimum two-week debating period required for other proposals.

[37] Because, as described above, DAO Token holders were incentivized either to vote yes or to abstain from voting, the results of DAO Token holder voting would not necessarily reflect the actual view of a majority of DAO Token holders.

pay off.”). *See also generally SEC v. Merchant Capital, LLC*, 483 F.3d 747 (11th Cir. 2007) (finding an investment contract even where voting rights were provided to purported general partners, noting that the voting process provided limited information for investors to make informed decisions, and the purported general partners lacked control over the information in the ballots).

The voting rights afforded DAO Token holders did not provide them with meaningful control over the enterprise, because (1) DAO Token holders' ability to vote for contracts was a largely perfunctory one; and (2) DAO Token holders were widely dispersed and limited in their ability to communicate with one another.

First, as discussed above, DAO Token holders could only vote on proposals that had been cleared by the Curators.[38] And that clearance process did not include any mechanism to provide DAO Token holders with sufficient information to permit them to make informed voting decisions. Indeed, based on the particular facts concerning The DAO and the few draft proposals discussed in online forums, there are indications that contract proposals would not have necessarily provide enough information for investors to make an informed voting decision, affording them less meaningful control. For example, the sample contract proposal attached to the White Paper included little information concerning the terms of the contract. Also, the Slock.it co-founders put forth a draft of their own contract proposal and, in response to questions and requests to negotiate the terms of the proposal (posted to a DAO forum), a Slock.it founder explained that the proposal was intentionally vague and that it was, in essence, a take it or leave it proposition not subject to negotiation or feedback. *See, e.g., SEC v. Shields*, 744 F.3d 633, 643-45 (10th Cir. 2014) (in assessing whether agreements were investment contracts, court looked to whether "the investors actually had the type of control reserved under the agreements to obtain access to information necessary to protect, manage, and control their investments at the time they purchased their interests.").

Second, the pseudonymity and dispersion of the DAO Token holders made it difficult for them to join together to effect change or to exercise meaningful control. Investments in The DAO were made pseudonymously (such that the real-world identities of investors are not apparent), and there was great dispersion among those individuals and/or entities who were invested in The DAO and thousands of individuals and/or entities that traded DAO Tokens in the secondary market—an arrangement that bears little resemblance to that of a genuine general partnership. *Cf. Williamson v. Tucker*, 645 F.2d 404, 422-24 (5th Cir. 1981) ("[O]ne would not expect partnership interests sold to large numbers of the general public to provide any real partnership control; at some point there would be so many [limited] partners that a partnership vote would be more like a corporate vote, each partner's role having been diluted to the level of a single shareholder in a corporation.").[39] Slock.it did create and maintain online forums on which

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[38] Because, in part, The DAO never commenced its business operations funding projects, this Report does not analyze the question whether anyone associated with The DAO was an "[i]nvestment adviser" under Section 202(a)(11) of the Investment Advisers Act of 1940 ("Advisers Act"). *See* 15 U.S.C. § 80b-2(a)(11). Those who would use virtual organizations should consider their obligations under the Advisers Act.

[39] The Fifth Circuit in *Williamson* stated that:

investors could submit posts regarding contract proposals, which were not limited to use by DAO Token holders (anyone was permitted to post). However, DAO Token holders were pseudonymous, as were their posts to the forums. Those facts, combined with the sheer number of DAO Token holders, potentially made the forums of limited use if investors hoped to consolidate their votes into blocs powerful enough to assert actual control. This was later demonstrated through the fact that DAO Token holders were unable to effectively address the Attack without the assistance of Slock.it and others. The DAO Token holders' pseudonymity and dispersion diluted their control over The DAO. *See Merchant Capital*, 483 F.3d at 758 (finding geographic dispersion of investors weighing against investor control).

These facts diminished the ability of DAO Token holders to exercise meaningful control over the enterprise through the voting process, rendering the voting rights of DAO Token holders akin to those of a corporate shareholder. *Steinhardt Group, Inc. v. Citicorp.*, 126 F.3d 144, 152 (3d Cir. 1997) ("It must be emphasized that the assignment of nominal or limited responsibilities to the participant does not negate the existence of an investment contract; where the duties assigned are so narrowly circumscribed as to involve little real choice of action … a security may be found to exist … . [The] emphasis must be placed on economic reality.") (citing *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 483 n. 14 (5th Cir. 1974)).

By contract and in reality, DAO Token holders relied on the significant managerial efforts provided by Slock.it and its co-founders, and The DAO's Curators, as described above. Their efforts, not those of DAO Token holders, were the "undeniably significant" ones, essential to the overall success and profitability of any investment into The DAO. *See Glenn W. Turner,* 474 F.2d at 482.

C. Issuers Must Register Offers and Sales of Securities Unless a Valid Exemption Applies

The definition of "issuer" is broadly defined to include "every person who issues or proposes to issue any security" and "person" includes "any unincorporated organization." 15 U.S.C. § 77b(a)(4). The term "issuer" is flexibly construed in the Section 5 context "as issuers devise new ways to issue their securities and the definition of a security itself expands." *Doran v. Petroleum Mgmt. Corp.*, 545 F.2d 893, 909 (5th Cir. 1977); *accord SEC v. Murphy*, 626 F.2d 633, 644 (9th Cir. 1980) ("[W]hen a person [or entity] organizes or sponsors the organization of

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> A general partnership or joint venture interest can be designated a security if the investor can establish, for example, that (1) an agreement among the parties leaves so little power in the hands of the partner or venture that the arrangement in fact distributes power as would a limited partnership; or (2) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers.

Williamson, 645 F.2d at 424 & n.15 (court also noting that, "this is not to say that other factors could not also give rise to such a dependence on the promoter or manager that the exercise of partnership powers would be effectively precluded.").

limited partnerships and is primarily responsible for the success or failure of the venture for which the partnership is formed, he will be considered an issuer … .").

The DAO, an unincorporated organization, was an issuer of securities, and information about The DAO was "crucial" to the DAO Token holders' investment decision. *See Murphy*, 626 F.2d at 643 ("Here there is no company issuing stock, but instead, a group of individuals investing funds in an enterprise for profit, and receiving in return an entitlement to a percentage of the proceeds of the enterprise.") (citation omitted). The DAO was "responsible for the success or failure of the enterprise," and accordingly was the entity about which the investors needed information material to their investment decision. *Id.* at 643-44.

During the Offering Period, The DAO offered and sold DAO Tokens in exchange for ETH through The DAO Website, which was publicly-accessible, including to individuals in the United States. During the Offering Period, The DAO sold approximately 1.15 billion DAO Tokens in exchange for a total of approximately 12 million ETH, which was valued in USD, at the time, at approximately $150 million. Because DAO Tokens were securities, The DAO was required to register the offer and sale of DAO Tokens, unless a valid exemption from such registration applied.

Moreover, those who participate in an unregistered offer and sale of securities not subject to a valid exemption are liable for violating Section 5. *See, e.g.*, *Murphy*, 626 F.2d at 650-51 ("[T]hose who ha[ve] a necessary role in the transaction are held liable as participants.") (citing *SEC v. North Am. Research & Dev. Corp.*, 424 F.2d 63, 81 (2d Cir. 1970); *SEC v. Culpepper*, 270 F.2d 241, 247 (2d Cir. 1959); *SEC v. International Chem. Dev. Corp.*, 469 F.2d 20, 28 (10th Cir. 1972); *Pennaluna & Co. v. SEC*, 410 F.2d 861, 864 n.1, 868 (9th Cir. 1969)); *SEC v. Softpoint, Inc.*, 958 F. Supp 846, 859-60 (S.D.N.Y. 1997) ("The prohibitions of Section 5 … sweep[] broadly to encompass 'any person' who participates in the offer or sale of an unregistered, non-exempt security."); *SEC v. Chinese Consol. Benevolent Ass'n.*, 120 F.2d 738, 740-41 (2d Cir. 1941) (defendant violated Section 5(a) "because it engaged in selling unregistered securities" issued by a third party "when it solicited offers to buy the securities 'for value'").

D. A System that Meets the Definition of an Exchange Must Register as a National Securities Exchange or Operate Pursuant to an Exemption from Such Registration

Section 5 of the Exchange Act makes it unlawful for any broker, dealer, or exchange, directly or indirectly, to effect any transaction in a security, or to report any such transaction, in interstate commerce, unless the exchange is registered as a national securities exchange under Section 6 of the Exchange Act, or is exempted from such registration. *See* 15 U.S.C. §78e. Section 3(a)(1) of the Exchange Act defines an "exchange" as "any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood … ." 15 U.S.C. § 78c(a)(1).

Exchange Act Rule 3b-16(a) provides a functional test to assess whether a trading system meets the definition of exchange under Section 3(a)(1). Under Exchange Act Rule 3b-16(a), an organization, association, or group of persons shall be considered to constitute, maintain, or provide "a marketplace or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange," if such organization, association, or group of persons: (1) brings together the orders for securities of multiple buyers and sellers; and (2) uses established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of the trade.[40]

A system that meets the criteria of Rule 3b-16(a), and is not excluded under Rule 3b-16(b), must register as a national securities exchange pursuant to Sections 5 and 6 of the Exchange Act[41] or operate pursuant to an appropriate exemption. One frequently used exemption is for alternative trading systems ("ATS").[42] Rule 3a1-1(a)(2) exempts from the definition of "exchange" under Section 3(a)(1) an ATS that complies with Regulation ATS,[43] which includes, among other things, the requirement to register as a broker-dealer and file a Form ATS with the Commission to provide notice of the ATS's operations. Therefore, an ATS that operates pursuant to the Rule 3a1-1(a)(2) exemption and complies with Regulation ATS would not be subject to the registration requirement of Section 5 of the Exchange Act.

The Platforms that traded DAO Tokens appear to have satisfied the criteria of Rule 3b-16(a) and do not appear to have been excluded from Rule 3b-16(b). As described above, the Platforms provided users with an electronic system that matched orders from multiple parties to buy and sell DAO Tokens for execution based on non-discretionary methods.

IV. Conclusion and References for Additional Guidance

Whether or not a particular transaction involves the offer and sale of a security—regardless of the terminology used—will depend on the facts and circumstances, including the

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[40] *See* 17 C.F.R. § 240.3b-16(a). The Commission adopted Rule 3b-16(b) to exclude explicitly certain systems that the Commission believed did not meet the exchange definition. These systems include systems that merely route orders to other execution facilities and systems that allow persons to enter orders for execution against the bids and offers of a single dealer system. *See* Securities Exchange Act Rel. No. 40760 (Dec. 8, 1998), 63 FR 70844 (Dec. 22, 1998) (Regulation of Exchanges and Alternative Trading Systems) ("Regulation ATS"), 70852.

[41] 15 U.S.C. § 78e. A "national securities exchange" is an exchange registered as such under Section 6 of the Exchange Act. 15 U.S.C. § 78f.

[42] Rule 300(a) of Regulation ATS promulgated under the Exchange Act provides that an ATS is:

> any organization, association, person, group of persons, or system: (1) [t]hat constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange within the meaning of [Exchange Act Rule 3b-16]; and (2) [t]hat does not: (i) [s]et rules governing the conduct of subscribers other than the conduct of subscribers' trading on such [ATS]; or (ii) [d]iscipline subscribers other than by exclusion from trading.

Regulation ATS, *supra* note 40, Rule 300(a).

[43] *See* 17 C.F.R. § 240.3a1-1(a)(2). Rule 3a1-1 also provides two other exemptions from the definition of "exchange" for any ATS operated by a national securities association, and any ATS not required to comply with Regulation ATS pursuant to Rule 301(a) of Regulation ATS. *See* 17 C.F.R. §§ 240.3a1-1(a)(1) and (3).

economic realities of the transaction. Those who offer and sell securities in the United States must comply with the federal securities laws, including the requirement to register with the Commission or to qualify for an exemption from the registration requirements of the federal securities laws. The registration requirements are designed to provide investors with procedural protections and material information necessary to make informed investment decisions. These requirements apply to those who offer and sell securities in the United States, regardless whether the issuing entity is a traditional company or a decentralized autonomous organization, regardless whether those securities are purchased using U.S. dollars or virtual currencies, and regardless whether they are distributed in certificated form or through distributed ledger technology. In addition, any entity or person engaging in the activities of an exchange, such as bringing together the orders for securities of multiple buyers and sellers using established non-discretionary methods under which such orders interact with each other and buyers and sellers entering such orders agree upon the terms of the trade, must register as a national securities exchange or operate pursuant to an exemption from such registration.

To learn more about registration requirements under the Securities Act, please visit the Commission's website here. To learn more about the Commission's registration requirements for investment companies, please visit the Commission's website here. To learn more about the Commission's registration requirements for national securities exchanges, please visit the Commission's website here. To learn more about alternative trading systems, please see the Regulation ATS adopting release here.

For additional guidance, please see the following Commission enforcement actions involving virtual currencies:

- *SEC v. Trendon T. Shavers and Bitcoin Savings and Trust*, Civil Action No. 4:13-CV-416 (E.D. Tex., complaint filed July 23, 2013)
- *In re Erik T. Voorhees*, Rel. No. 33-9592 (June 3, 2014)
- *In re BTC Trading, Corp. and Ethan Burnside*, Rel. No. 33-9685 (Dec. 8, 2014)
- *SEC v. Homero Joshua Garza, Gaw Miners, LLC, and ZenMiner, LLC (d/b/a Zen Cloud)*, Civil Action No. 3:15-CV-01760 (D. Conn., complaint filed Dec. 1, 2015)
- *In re Bitcoin Investment Trust and SecondMarket, Inc.*, Rel. No. 34-78282 (July 11, 2016)
- *In re Sunshine Capital, Inc.*, File No. 500-1 (Apr. 11, 2017)

And please see the following investor alerts:

- *Bitcoin and Other Virtual Currency-Related Investments* (May 7, 2014)
- *Ponzi Schemes Using Virtual Currencies* (July 2013)

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CFTC Jurisdiction Over Cryptocurrency – Implications for Industry Participants

Ether is a cryptocurrency generated by the Ethereum platform. Ether is also the underlying currency behind the Ethereum blockchain. Although, like Bitcoin, it has become a tradeable digital currency, it primarily functions as the fuel for running commands on the Ethereum platform. The Commodity Futures Trading Commission has signaled that it will now treat a cryptocurrency such as this as a commodity. Digital assets like Ether should now expect to be subject to the Commission's rules and regulations. The authors of this article discuss the issue and advise industry participants to be prepared to face the compliance burdens associated with the registration, anti-fraud, and anti-manipulation obligations.

Ethereum is an open source, public, blockchain-based distributed computing platform and operating system. Ether is a cryptocurrency generated by the Ethereum platform. Ether is also the underlying currency behind the Ethereum blockchain; although, like Bitcoin, it has become a tradeable digital currency, it primarily functions as the fuel for running commands on the Ethereum platform.

Commodity Futures Trading Commission ("CFTC") Chairman Heath Tarbert recently commented on Ether's status as a commodity:

> We've been very clear on bitcoin: bitcoin is a commodity under the Commodity Exchange Act. We haven't said anything about Ether – until now. It is my view as Chairman of the CFTC that Ether is a commodity, and therefore it will be regulated under the CEA. And my guess is that you will see, in the near future, Ether-related futures contracts and other derivatives potentially traded. . . . *It's my conclusion as Chairman of the CFTC that Ether is a commodity and therefore would fall under our jurisdiction*.

The CFTC chairman's signal that it will now treat a cryptocurrency such as this as a commodity represents a significant development in the digital asset regulatory landscape. Digital assets like Ether should now expect to be subject to the CFTC's rules and regulations, and industry participants should be prepared to face the compliance burdens associated with the CFTC's registration, anti-fraud, and anti-manipulation obligations.

CFTC Jurisdiction

The mission of the CFTC is to foster open, transparent, competitive, and financially sound markets. To achieve this aim, the CFTC administers and enforces the Commodity Exchange Act ("CEA") and its respective regulations. The CFTC has exclusive jurisdiction over, among others, any transaction "for the contract of sale of a commodity for future delivery," with certain exceptions. Consequently, commodities are generally subject to the regulatory requirements of the CEA. In addition, market participants in commodities face CFTC registration requirements for traders, advisors, agents and exchanges as well as enforcement actions brought by the CFTC's Division of Enforcement for violations of fraud and manipulation rules and regulations. As Chairman Tarbert now categorizes Ether as a commodity, we expect it could become subject to the full gamut of the CFTC's regulations and actions.

Fraud and Manipulation Rules Generally

Following the passage of the Dodd Frank Wall Street Reform and Consumer Protection Act, the CFTC adopted rules and regulations prohibiting the employment, or attempted employment, of manipulative or deceptive conduct. The CEA's fraud rule was modeled after Section 10(b) and Rule 10b-5 of the Securities and Exchange Act of 1934 as amended to broadly prohibit fraud and fraud-based manipulation.

Relatedly, the CEA's manipulation rule makes it unlawful for any person, directly or indirectly, to manipulate or attempt to manipulate the price of any swap or commodity in interstate commerce. These new rules broadened the CFTC's existing authority to prohibit fraud and manipulation by eliminating the requirement to show an artificial price, lowering scienter from specific intent to recklessness in certain instances, and expanding the prohibition on false reporting to include "any false statement of material fact" to the CFTC in any context.

Fraud Rule

The CFTC's fraud rule makes it unlawful for any person, directly or indirectly, in connection with any swap or contract of sale of any commodity or contract for future delivery, on or subject to the rules of any regulated exchange or trading facility, to intentionally or recklessly:

- Use or employ, or attempt to use or employ, any manipulative device, scheme or artifice to defraud;
- Make, or attempt to make, any untrue or misleading statement of a material fact or to omit to state a material fact necessary in order to make the statements made not untrue or misleading;
- Engage, or attempt to engage, in any act, practice, or course of business that operates or would operate as a fraud or deceit upon any person; or
- Deliver or cause to be delivered, or attempt to deliver or cause to be delivered, a false or misleading or inaccurate report concerning crop or market information or conditions that affect or tend to affect the

price of any commodity in interstate commerce, knowing or acting in reckless disregard of the fact that such report is false, misleading or inaccurate.

The CEA stated that there is no violation of the fraud rule when a person mistakenly transmits, in good faith, false or misleading or inaccurate information to a price reporting service. Nonetheless, the CFTC takes a broad view of the rule's reach, indicating in the rule's release that it will interpret the rule "not technically and restrictively, but flexibly to effectuate its remedial purposes."

Manipulation Rule

The CFTC's manipulation rule makes it unlawful for any person, directly or indirectly, to manipulate or attempt to manipulate the price of any swap or commodity. The CFTC's traditional four-part test for manipulation guides its enforcement efforts. Under this test, a violation occurs when:

- The alleged manipulator had the ability to influence market prices.
- The alleged manipulator specifically intended to create or effect a price or price trend that does not reflect legitimate forces of supply and demand.
- Artificial prices existed.
- The alleged manipulator caused the artificial prices.

Common Violations of the CEA

Common violations of the CEA's fraud and manipulation rules include failures to register with the CFTC as well as various forms of fraud and manipulation schemes. The CFTC aggressively enforces violations of the CEA, which may now extend to digital asset market participants following Chairman Tarbert's comments on Ether's status as a commodity.

False Representations

Lately, the CFTC has brought cases against individuals and entities that make false representations regarding cryptocurrency trading expertise and activity. For example, the CFTC on October 16, 2019 charged a Nevada company with fraudulently soliciting $11 million worth of Bitcoin and cash as part of a Ponzi-like scheme that included misrepresentations of trading expertise and guaranteed rates of return.

Similarly, on June 18, 2019, the CFTC charged a Bitcoin trader and his firm with misappropriating $147 million in Bitcoin through material misrepresentations and omissions in a pyramid-like scheme. The CFTC has thus already initiated enforcement of the CEA against participants in the digital asset industry and seems poised to extend its scope of enforcement activities to other forms of CEA violations conducted by those in the digital asset industry.

Furthermore, the most recent version of the proposed CFTC Reauthorization Act of 2019, as favorably reported to the House by the House Agriculture Committee, would materially extend the commission's extraterritorial jurisdiction by amending the CEA to provide that its provisions prohibiting fraud, manipulation, attempted fraud and attempted manipulation would apply to "activities outside the United States where such activities, independently or in conjunction with activities in the United States, have or would have a reasonably foreseeable substantial effect within the United States."

Failure to Register

The CFTC requires registration of any:

- Commodity Pool Operator — An individual or organization that operates a commodity pool and solicits funds for that commodity pool;
- Commodity Trading Advisor — An individual or organization that, for compensation or profit, advises others, directly or indirectly, as to the value of or the advisability of trading futures contracts, options on futures, retail off-exchange forex contracts or swaps;
- Futures Commission Merchant — An entity that solicits or accepts orders to buy or sell futures contracts, options on futures, retail off-exchange forex contracts or swaps, and accepts money or other assets from customers to support such orders;
- Introducing Broker — An individual or organization that solicits or accepts orders to buy or sell futures contracts, forex, commodity options, or swaps but does not accept money or other assets from customers to support these orders; or
- Associated Person — An individual who solicits orders, customers or customer funds (or who supervises persons so engaged) on behalf of a futures commission merchant, retail foreign exchange dealer, introducing broker, commodity trading advisor or commodity pool operator.

The CFTC takes failures to register seriously and has already signaled a willingness to bring enforcement actions against those in the digital asset business. For example, on October 31, 2019, the CFTC charged a Switzerland-based digital asset exchange for its failure to register as a Futures Commission Merchant. The CFTC fined the exchange $100,000 and seized its online domain. Since the CFTC may now treat other cryptocurrencies as a commodity, entities that operate in the digital asset market must now harbor heightened vigilance with respect to their CFTC registration obligations.

Fictitious Sales

Common fraud tactics that may now extend to transactions in digital assets include schemes known as "fictitious sales." Typically, fictitious sales take the form of wash sales and accommodation trades.

A wash sale occurs when one sells or trades securities at a loss and, within 30 days before or after the sale, one either buys substantially identical securities, acquires substantially identical securities in a fully taxable trade, or acquires a contract or option to buy substantially identical securities. Wash sales typically are accomplished in two ways: by a trader (1) buying and selling with himself or herself, or (2) buying and selling with another person pursuant to a prearranged plan or understanding.

Accommodation trading, on the other hand, occurs when a trader engages in non-competitive trading, usually to assist another with illegal trades, such as a sale at a below market price intended to create a short-term trading loss for tax purposes that is later reversed. Traders in digital assets must now ensure that their activities do not fall into either of these fictitious sale categories.

Violating Bids and Offers

Violating bids and offers is another common fraud tactic that may extend to the digital asset landscape. The CFTC interprets its fraud rule in this context as operating in any trading environment where a person is not utilizing trading algorithms that automatically match the best price for bids and offers. The CFTC prohibits purchases of any contract on a registered entity at a price that is higher than the lowest available price offered for such contract or selling a contract on a registered entity at a price that is lower than the highest available price bid for such contract. Parties transacting in commodities like Ether must now evaluate and maintain compliance with such bid and offer restrictions.

Spoofing

Spoofing, defined as bidding or offering with the intent to cancel the bid or offer before execution, is a common manipulation tactic that extends into the trading of digital assets. The CFTC enforces its anti-spoofing measures against significant market participants. For example, on October 1, 2019, the CFTC ordered two prominent trading firms and a bank to pay a total of $3 million in civil monetary penalties in connection with multiple acts of spoofing on various commodity exchanges. Since cryptocurrencies are now under the purview of the CFTC's authority, it is important for market participants to refrain from the types of activities that may trigger enforcement actions by the CFTC.

Misappropriation and Front Running

The CEA prohibits the misappropriation of non-public information to enter into commodity, option, or swap transactions. Under a misappropriation theory generally, fraud occurs when a person misappropriates confidential information for trading purposes, in breach of a duty owed to the source of the information. The CEA extends misappropriation theory to any person who engages in deceptive or manipulative conduct in connection with any swap or contract of sale of any commodity in interstate commerce or contract for future delivery.

Front running occurs when one takes a futures or option position based upon non-public information (perhaps misappropriated) regarding an impending transaction by another person in the same or related future or option. By trading ahead of non-public information, this activity violates the CEA's prohibition on fraud. Participants in the digital asset market must therefore refrain from misappropriation and any subsequent front running with respect to information regarding digital assets like Ether and their attendant transactions.

Conclusion

The CFTC's jurisdiction and regulatory framework over market participants' proper registration, as well as over fraudulent and manipulation activities, should now be expected to extend to the digital assets industry. Accordingly, industry participants should prepare to shoulder the associated compliance burden by building and maintaining strong compliance controls and procedures and implementing policies that ensure timely and ongoing compliance with the CEA.

Tab 38 – Coinbase S-1

Please see the following link for the Coinbase S-1:
https://www.sec.gov/Archives/edgar/data/0001679788/000162828021005373/coinbaseglobalincs-1a2.htm

CONFIDENTIAL PRIVATE PLACEMENT MEMORANDUM

PANTERA BITCOIN FUND LTD

a Cayman Islands Exempted Company

March 2021

DIRECTORY

PANTERA BITCOIN FUND LTD

Please direct investor inquiries to the Investor Relations Department (Telephone No.: 415-360-3600; E-mail: ir@panteracapital.com).

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Cayman Islands

CONFIDENTIAL PRIVATE PLACEMENT MEMORANDUM

PANTERA BITCOIN FUND LTD

Pantera Bitcoin Fund Ltd (the "Fund") has offered and is currently offering the Shares described in this Confidential Private Placement Memorandum (this "Memorandum") to certain qualified investors that, if accepted, will become shareholders of the Fund (the "Shareholders"). The first closing of the Fund with respect to its investment in Bitcoin occurred in July 2013.

Prospective investors should carefully read this Memorandum in its entirety. However, the contents of this Memorandum should not be considered to be investment, legal or tax advice, and each prospective investor should consult with its own counsel and advisers as to all matters concerning an investment in the Fund.

There will be no public offering of the Shares. No offer to sell (or solicitation of an offer to buy) is being made in any jurisdiction in which such offer or solicitation would be unlawful.

This Memorandum has been prepared for the information of the person to whom it has been delivered (the "Recipient") by or on behalf of the Fund, and may not be reproduced or used for any other purpose. By accepting this Memorandum, the Recipient agrees (i) not to reproduce or distribute this Memorandum, in whole or in part, without the prior written consent of the Fund or its authorized representatives, (ii) to return this Memorandum to the Fund or its authorized representatives upon request and (iii) not to disclose any information contained in this Memorandum or any other information relating to the Fund to any person who is not a trustee, director, officer, employee, auditor, agent, attorney, financial adviser or other professional adviser responsible for matters relating to the Fund or who otherwise has a need to know such information in connection with such person's responsibilities with respect to the Recipient and who is under an obligation to keep such information confidential, except to the extent such information is in the public domain (other than as a result of any action or omission of the Recipient or permitted person to whom the Recipient has disclosed such information). Notwithstanding anything to the contrary in this Memorandum, each investor (and each employee, representative or other agent of such investor) may disclose to any and all persons, without limitation of any kind, the tax treatment and tax structure of (i) the Fund and (ii) any of the Fund's transactions, and all materials of any kind (including opinions or other tax analyses) that are provided to such investor relating to such tax treatment and tax structure, it being understood that "tax treatment" and "tax structure" do not include the name or the identifying information of (i) the Fund or (ii) the parties to a transaction.

This Memorandum is accurate as of its date in all material aspects, and no representation or warranty is made as to its continued accuracy after such date. None of the Fund or any of its authorized representatives has any obligation to update this Memorandum at any time in the future. Information contained in this Memorandum is subject to modification, supplementation and amendment at any time and from time to time. Each investor will be required to acknowledge that it made an independent decision to invest in the Fund and that it is not relying on the Fund, the Administrator, the Investment Manager or any other person or entity (other than such investor's own advisers) with respect to the legal, tax, financial, risk or other considerations involved in an investment in the Fund. Past performance is no guarantee of future results.

This Memorandum has been prepared by the Investment Manager on behalf of the Fund, which has the ultimate authority over its contents. Other than the Investment Manager, no investor shall be responsible for any statements in this Memorandum.

Statements contained in this Memorandum (including those related to current and future market conditions and trends in respect thereof) that are not historical facts are based on current expectations, estimates, projections, opinions and/or beliefs of the Investment Manager or the Fund. Such statements and certain other information contained in this Memorandum constitute "forward-looking statements", which can be identified by the use of forward-looking terminology such as "may", "will", "should", "expect", "anticipate", "target", "project", "estimate", "intend", "continue" or "believe", or the negatives thereof or other variations thereon or comparable terminology. Due to various risks and uncertainties, actual events or results of the actual performance of any investment made by the Fund may differ materially from those reflected or contemplated in such forward-looking statements.

Each prospective or current investor, when making its decision to subscribe for Shares or making a subsequent investment decision with respect to the Fund, can rely only on information included in this Memorandum and any Additional Information (irrespective of any other information furnished to such investor). "Additional Information" means any information, other than information included in this Memorandum, concerning the terms and conditions of the Shares or the status of the Fund, communicated in writing to a prospective or current investor by the Fund or the Investment Manager and expressly identified as "Additional Information". If Additional Information contradicts, modifies, supplements or amends any information included in this Memorandum, this Memorandum will control, unless the Fund or its authorized representative expressly indicates in writing that such Additional Information modifies, supplements or amends the information included in this Memorandum.

The Shares are offered subject to prior sale, and subject to the right of the Fund to reject any subscription in whole or in part.

The Shares are suitable only for sophisticated investors (i) that do not require immediate liquidity for their investments, (ii) for which an investment in the Fund does not constitute a complete investment program and (iii) that fully understand and are willing and able to assume the risks of an investment in the Fund. Each subscriber for Shares will be required to represent that it is acquiring the Shares for its own account, for investment purposes only and not with a view toward distributing or reselling the Shares in whole or in part. There is no established secondary market for the Shares, and none is expected to develop. Given the investment program of the Fund and the redemption terms of the Fund, it is expected that (i) the assets of the Fund will experience significant volatility; (ii) the Investment Manager will have difficulty buying and selling assets for the Fund; and (iii) investors will be subject to delays in subscribing for and redeeming Shares.

The Shares are subject to limited liquidity and significant restrictions on transferability and resale. Investors will be required to bear the financial risks of an investment in the Fund for an indefinite period of time. Investment in the Fund involves the risk of loss of the entire value of an investor's investment in the Fund.

All references herein to "U.S. dollars" or "$" are to the lawful currency of the United States.

The Shares have not been, and will not be, registered under the U.S. Securities Act of 1933, as amended (the "Securities Act"), or any U.S. state securities laws or the laws of any other jurisdiction and, therefore, cannot be resold, reoffered or otherwise transferred unless they are so registered or an exemption from registration is available. The Shares will be offered and sold under the exemption provided by Section 4(a)(2) of the Securities Act and Regulation D promulgated thereunder and other exemptions of similar effect under U.S. state laws and the laws of other jurisdictions where the offering will be made.

The Fund is not registered as an investment company under the U.S. Investment Company Act of 1940, as amended (the "Company Act"). Consequently, the Fund will not be required to adhere to certain restrictions and requirements under the Company Act, and investors will not be afforded the protections of the Company Act.

The Fund will not trade, buy, sell or hold Bitcoin derivatives including Bitcoin futures contracts. The Fund is solely authorized to take immediate delivery of Bitcoin. The Fund is not, and does not expect to become, regulated by the Commodity Futures Trading Commission ("CFTC") under the Commodity Exchange Act as a "commodity pool," and will not be operated by a CFTC-regulated commodity pool operator because it will not trade, buy, sell or hold Bitcoin derivatives, including Bitcoin futures contracts. Shareholders in the Fund will not receive the regulatory protections afforded to investors in regulated commodity pools, nor may any exchange enforce its rules with respect to the Fund's activities. In addition, Shareholders in the Fund will not benefit from the protections afforded to investors in Bitcoin futures contracts on regulated futures exchanges.

The Investment Manager does not believe that the Fund or the Investment Manager is, or will be, required to (a) register as a Money Services Business with the Financial Crimes Enforcement Network of the U.S. Department of the Treasury ("FinCEN"); (b) obtain a money transmitter license with the banking department of any state, or (c) obtain a license under the Cayman Islands Money Services Act (Revised) ("Money Services Act"), and therefore has not done so. There is a risk that the Investment Manager and/or the Fund will be considered a Money Services Business and will be required to register with FinCEN, obtain money transmitter licenses from state banking departments and/or obtain a license under the Money Services Act.

The Fund is a regulated mutual fund for the purposes of the Mutual Funds Act (as amended) of the Cayman Islands (the "Mutual Funds Act"). The Fund is registered with the Cayman Islands Monetary Authority (the "Monetary Authority") pursuant to section 4(3) of that law and the prescribed details in respect of this Memorandum and the Fund have been filed with *the Monetary Authority. Such registration does not imply that the Monetary Authority or any other governmental body has approved this Memorandum or passed judgment on the offering of Shares hereunder. (See "Regulatory Matters — Cayman Islands Mutual Funds Act".) A mutual fund licence issued or a fund registered by the Monetary Authority does not constitute an obligation of the Monetary Authority to any investor as to the performance or creditworthiness of the fund. Furthermore, in issuing such a licence or in registering a fund, the Monetary Authority shall not be liable for any losses or default of the fund or for the correctness of any opinions or statements expressed in any prospectus or offering document.*

This Memorandum is based on the law and practice currently in force in the Cayman Islands and is subject to changes therein. No invitation to subscribe for shares may be made to the public in the Cayman Islands and this Memorandum does not represent such an invitation. Any Shares which are sold or transferred in violation of the prohibitions set out in this Memorandum may be redeemed involuntarily by the Fund. This Memorandum should be read in conjunction with the Amended and Restated Memorandum and Articles of Association of the Fund, as the same may be amended from time to time (the "Articles of Association").

In making an investment decision, investors must rely upon their own examination of the Fund and the terms of the offering, including the merits and risks involved. The Shares have not been filed with, registered, approved by or disapproved by the U.S. Securities and Exchange Commission (the "SEC") or any other governmental agency, regulatory authority or national securities exchange of any country or jurisdiction, with the exception of filing this document with the Monetary Authority. No such agency, authority or exchange has passed upon the accuracy or adequacy of this Memorandum or the merits of an investment in the Shares offered hereby. Any representation to the contrary is a criminal offense.

Certain information contained herein concerning economic trends and performance are based on or derived from information provided by independent third-party sources. The Investment Manager believes that such information is accurate and that the sources from which it has been obtained are reliable. The Investment Manager cannot guarantee the accuracy of such information, however, and has not independently verified the assumptions on which such information is based.

Whenever in this Memorandum the Board of Directors, the Investment Manager, its affiliates or any other person is permitted or required to make a decision (i) in its "discretion" or under a grant of similar authority or latitude, such person will be entitled to consider such interests and factors as it desires, including its own interests, or (ii) in its "good faith" or under another express standard, such person will act under such express standard, will not be subject to any other or different standard imposed by applicable law and may exercise its discretion differently with respect to different Shareholders.

Prospective investors should consult Appendix B hereto for a listing of restrictions on offerings and sales in certain jurisdictions. The information set forth in Appendix B was obtained from a third-party law firm that prepared such information (i) in consultation with local counsel, where necessary, and (ii) based on a hypothetical offering structure commonly used by private investment funds. Neither Schulte Roth & Zabel LLP ("SRZ") nor Ogier prepared the information set forth in Appendix B (other than the information for (i) prospective Shareholders in the United Kingdom, which was prepared by SRZ, and (ii) prospective Shareholders in the Cayman Islands, which was prepared by Ogier). Neither SRZ nor Ogier has researched or verified the accuracy or completeness of the information. None of the Investment Manager or the Fund prepared, researched or verified the contents of such information.

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PANTERA BITCOIN FUND LTD

SUMMARY OF TERMS

The following is a summary of the principal terms of the Fund. This summary is qualified in its entirety by the more detailed information set forth in this Memorandum, any Supplement to this Memorandum, the Articles of Association and the Investment Management Agreement, each of which is available upon request, and each Shareholder's Subscription Agreement (collectively, the "Fund Documents"). This summary should be read in conjunction with such detailed information. In the event that any information in this Memorandum contradicts information set forth in any other Fund Document, the applicable Fund Document will control.

THE FUND:	The Fund The Fund is an exempted company formed under the laws of the Cayman Islands on June 9, 2004 to operate as a private investment fund for the benefit of non-U.S. Persons and U.S. Persons. The Fund was incorporated with the name Pantera Systems Master Fund Ltd and changed its name to Pantera Bitcoin Master Fund Ltd in September 2013 and to Pantera Bitcoin Fund Ltd in March 2014. (See "Certain Risk Factors – Historical Liabilities of the Fund".) Pantera Bitcoin Feeder Fund Ltd (the "Feeder Fund") is an exempted company formed under the laws of the Cayman Islands on June 25, 2019 to facilitate indirect investments by investors in the Fund. The Feeder Fund will invest all of its investable assets in the Fund. Each of the Fund and the Feeder Fund has unlimited duration. The Investment Manager may, in the future, establish other feeder funds that invest through the Fund and/or may establish investment vehicles that invest in parallel with the Fund as described below under "Related Investment Vehicles."
INVESTMENT PROGRAM:	The Fund will invest substantially all of its assets in Bitcoin. The Fund will only sell Bitcoin to fund redemptions and pay expenses and liabilities. The Fund will not trade, buy, sell or hold Bitcoin derivatives for any purpose. Transactions in Bitcoin will not be made on a leveraged, margined, or offer-financed basis. The Fund may engage in Bitcoin lending transactions, in the sole discretion of the Investment Manager. (See "Investment Program".) *The Fund's investment program is extremely speculative and entails substantial risks. There can be no assurance that the investment objectives of the Fund will be achieved. (See "Certain Risk Factors".)*

MANAGEMENT: The Investment Manager

Pantera Bitcoin Management LLC (the "Investment Manager"), a Delaware limited liability company, serves as the investment manager of the Fund. Daniel W. Morehead (the "Principal"), controls the Investment Manager. The Investment Manager is a wholly-owned subsidiary of Pantera Bitcoin Advisors LLC, a Delaware limited liability company (the "Advisor"). The Advisor is a wholly-owned subsidiary of Pantera Bitcoin Partners LLC ("Pantera Bitcoin"), a Delaware limited liability company. Pursuant to delegated investment discretion over the Fund's assets, the Investment Manager, in its capacity as the investment manager of the Fund, will act solely on behalf of the Fund, in what it determines to be the best interests of the Fund and for the benefit of the Fund.

The Board of Directors

The board of directors of the Fund (the "Board of Directors") has ultimate responsibility for the management, operations and the investment decisions made on behalf of the Fund, but has delegated investment discretion over the Fund's assets to the Investment Manager pursuant to the terms of the Investment Management Agreement. Consequently, the Board of Directors does not manage the day-to-day conduct of the Fund's trading activities and, pursuant to the Articles of Association of the Fund, has no authority to approve or deny subscriptions or redemptions. Additionally, the Board of Directors has delegated the calculation of net asset value and certain administrative, accounting, registrar and transfer agency responsibilities to the Administrator. References herein to the Board of Directors taking actions and making determinations on behalf of the Fund should be understood to mean actions taken and determinations made by the Board of Directors generally in consultation with the Investment Manager. Ryan Davis, Matt Gorham, Scott Lennon, Lisa Volekaert and Glenn Kennedy serve as directors of the Fund (each, a "Director").

OFFERING OF SHARES: Subject to the terms of the Articles of Association and to the condition that each new Shareholder execute a subscription agreement (a "Subscription Agreement"), the Fund may admit one or more new Shareholders and may accept subscriptions as of any Business Day (as defined below) or at such other times as the Investment Manager may determine in its sole discretion (each date on which all or a portion of a subscription is accepted, a "Subscription Date"). It is generally anticipated that the Investment Manager will not accept subscriptions on any Subscription Date for the Fund and the Related Investment Vehicles that, in the aggregate, exceeds 25% (or such other amount as determined in the Investment

Manager's sole discretion) (the "Subscription Percentage") of the median of the daily trading volume of Bitcoin on the Exchanges during the previous 20 Business Days (the "Median Daily Trading Volume"). The Investment Manager, in its sole discretion, may choose to accept subscriptions in excess of the Subscription Percentage, as well as limit subscriptions below the Subscription Percentage. The Investment Manager may utilize multiple subscription accounts at different banks and in multiple jurisdictions.

Investors must meet all anti-money laundering requirements before subscribing.

The "Exchanges" shall mean any exchanges determined by the Investment Manager, in its sole discretion. A "Business Day" shall mean the 24-hour period beginning at 12:00 a.m. Pacific time through 11:59 p.m. Pacific time on any day on which banks in New York (and any other jurisdictions that the Investment Manager determines are required for the Fund to transact business on such day) are open for business.

USE OF PROCEEDS: The proceeds from the sale or lending of Shares will be available for the Fund's investment program, after the payment of the Fund's expenses.

THE SHARES: The Fund is currently offering redeemable, participating non-voting shares of the Fund, being tranche A shares of the Fund ("Tranche A Shares") and tranche B shares of the Fund ("Tranche B Shares", together with the Tranche A Shares and such other shares of the Fund as the Fund may issue from time to time, the "Shares"), to certain qualified investors that, if accepted, will become Shareholders. The terms of each tranche of Shares established by the Fund (each, a "Tranche") are identical, except with respect to Management Fees and Realization Fees. The Advisor will hold all of the voting shares of the Fund.

Tranche A Shares are offered to all Shareholders in the Fund, other than Shareholders eligible to invest in Tranche B. Tranche B Shares are offered to the Investment Manager, its affiliates and their respective employees.

A Shareholder will be admitted to the Fund when all or any portion of its subscription amount leaves the subscription account, and may be issued tranche C shares of the Fund ("Tranche C Shares") in respect of such amount. Once a Shareholder's subscription funds have been received at the Fund's counterparty to a Bitcoin transaction or such funds have been applied by the Fund to pay expenses or satisfy redemptions, such Shareholder's Tranche C Shares will be converted to Tranche A Shares or Tranche B Shares, as applicable. Tranche C Shares are not subject to Management Fees and are not redeemable at the option of a Shareholder. Any gains and losses on Tranche C Shares will be allocable to the Fund as a whole.

The Shares are issued in registered, book-entry form at a purchase price of $0.01 per Share, subject to the minimum subscription amount, except as described in the following paragraph.

The Fund, in the sole discretion of the Board of Directors, may in the future establish additional Tranches having, or enter into Side Letters with Shareholders which provide for, different or additional terms than those described in this Memorandum, including, without limitation, different Management Fee rates, functional currencies, information rights and redemption rights. The Board of Directors may establish new Tranches and the Fund may enter into Side Letters with Shareholders, without providing prior notice to, or receiving consent from, other Shareholders. The Fund previously offered another Tranche of Shares which were subject to different fee terms, but such Shares are not being offered pursuant to this Memorandum. The terms of such Tranches or Side Letters will be determined by the Board of Directors and the Investment Manager in their sole discretion. (See "Other Activities of Management; Potential Conflicts of Interest — Side Letters".)

INITIAL AND ADDITIONAL SUBSCRIPTIONS:

The Investment Manager, in its sole discretion, may accept subscriptions for Shares in cash or in kind. The minimum initial subscription for each subscriber is $100,000, or (if the Investment Manager agrees in its sole discretion to accept a subscription in kind) its equivalent, as of the Subscription Date, in Bitcoin. A Shareholder may make additional subscriptions to the Fund in amounts of at least $50,000, or (if the Investment Manager agrees in its sole discretion to accept a subscription in kind) its equivalent, as of the Subscription Date, in Bitcoin. The Investment Manager, in its sole discretion, may accept subscriptions of lesser amounts or establish different minimums or reject, in whole or in part, any subscription, in whole or in part, for any reason or no reason; *provided* that at no time will the Fund accept a minimum initial subscription of less than $100,000, or (in the case of subscriptions in kind) its equivalent, as of the Subscription Date, in Bitcoin, or such other minimum amount as specified under Cayman Islands law from time to time.

All admission requirements must be satisfied, including, without limitation, anti-money laundering clearance, and subscription monies must be in the Fund's subscription account prior to the requested Subscription Date.

It is generally anticipated that subscriptions that satisfy the admission requirements before 10 a.m. Pacific time on a Business Day and subscription monies received before 10 a.m. Pacific time on a Business Day will be accepted into the Fund on the same Subscription Date. Subscriptions that do not meet such cut-off times on a given Subscription Date will be accepted into the Fund on subsequent Subscription Dates.

Subscription monies must be in the Fund's subscription account and all other admission requirements must be satisfied, including, without limitation, anti-money laundering clearance, at least one Business Day prior to the requested Subscription Date. The Investment Manager may accept amounts in the subscription account on any Subscription Date. Each Shareholder will receive written notice from the Administrator setting forth the amount of subscription monies invested in the Fund on each Business Day. To the extent that subscription monies are not invested (due to market conditions, multiple subscription requests or other factors), the Investment Manager shall invest such monies on the following Business Day or the next Business Day as determined by the Investment Manager in its sole discretion. Subscription monies will be held in a non-interest bearing subscription account (the "Bank Account") and will not be at risk of the Fund until the Investment Manager has drawn them for investment. Shares will be valued in accordance with the valuation procedures set forth herein as of the end of the Business Day on each Subscription Date. Subscription monies will not be subject to the Management Fee during any time such monies are in the Bank Account and will be charged the Management Fee beginning on the first day following the issuance of Shares to the Shareholder.

In the event that the Fund receives subscriptions on any Business Day that exceed the amount of Bitcoin that can be purchased within 5 Business Days of the subscription, the Investment Manager will delay subscriptions until adequate capacity exists.

For purposes of determining the subscription price, Bitcoin will be priced based on the time weighted average price in U.S. dollars of Bitcoin on the Exchanges (the "TWAP") as of the end of the Business Day on the Subscription Date. To determine TWAP for a Business Day, the Investment Manager will calculate the average price of Bitcoin in U.S. dollars on the Exchanges over the relevant Business Day.

Persons interested in acquiring Shares will be furnished, and will be required to complete and return to the Administrator, a Subscription Agreement and/or certain other documents as may be requested by the Investment Manager, in its sole discretion, for its initial and each additional subscription. The Subscription Agreement contains, among other provisions, certain representations, warranties, agreements, undertakings and acknowledgements relating to a prospective Shareholder's suitability to purchase Shares, the terms of the Shares, and other matters. Subscribers should understand that the Shares will be offered and sold in reliance upon the representations, warranties, agreements, undertakings and acknowledgements made by the subscriber in, and other information provided by the subscriber in connection with, the Subscription Agreement, and that such provisions may be asserted as a defense by the Fund and the Investment Manager in any action or proceeding relating to the offer and sale of Shares. Shareholders may be subject to contractual liability with respect to any breaches of such representations, warranties, agreements, undertakings and acknowledgements, and may be required to indemnify the Fund and /or the Investment Manager for any losses it incurs as a result of such breach, regardless of the limited liability status of the Fund.

The equity capitalization of the Fund and the acceptance of subscriptions will be determined by the Investment Manager, in its sole discretion, based on a number of factors, including the availability of investment opportunities. There are no minimum and maximum limitations on the amount of assets that may be managed by the Fund.

SALES CHARGES: There will be no sales charges payable to the Investment Manager or its affiliates in connection with the offering of Shares. However, the Investment Manager, its affiliates and/or the Fund may enter into agreements with placement agents providing for one-time or ongoing payments from the Fund based upon the amount of a Shareholder's subscriptions or the Management Fees borne by a Shareholder that was introduced to the Fund by the placement agent.

REDEMPTIONS: Voluntary Redemptions

Subject to the limitations on redemptions set forth herein, each Shareholder will have the right as of any Business Day (each day on which a redemption (or portion thereof) is effected, a "Redemption Date"), upon written notice to the Administrator, to request the redemption of all or a specified percentage of its Shares. It is generally anticipated that redemption notices received by the Administrator no later than 10 a.m. Pacific time on a Business Day will be satisfied as of the later of the Redemption Date requested in such notices and the next Business Day following receipt of such notices, subject to the limitations on redemptions set forth herein.

A redemption notice will be irrevocable unless the Investment Manager, in its sole discretion, permits the redemption notice to be revoked.

Generally, all redemption requests received by the Administrator with respect to each Redemption Date will be satisfied on a *pro rata* basis based on the amount of each Shareholder's requested redemption as of such date. However, in the event that the aggregate redemption requests from the Fund and the Related Investment Vehicles on a Redemption Date cannot be satisfied (including due to any lending of Bitcoin by the Fund) as determined by the Investment Manager, in its sole discretion, the Investment Manager may execute the redemption as soon as possible thereafter. Redemption requests received by the Administrator will generally be satisfied on a *pro rata* basis, based on the net asset value of the redeeming Shareholder's Shares with respect to each Redemption Date. Redemption requests will be satisfied on a first-in, first-out basis by intended Redemption Date and, for the avoidance of doubt, redemption requests requested to be made with respect to a particular Redemption Date but delayed as described above (such requests, the "<u>Delayed Redemptions</u>") will have priority over any later redemption requests.

A redeeming Shareholder will be entitled to receive redemption proceeds based on the net asset value of such Shareholder's Shares as of the Redemption Date, based on Bitcoin price based on the TWAP set on the applicable Redemption Date.

In the case of Delayed Redemptions, the Investment Manager will determine the portion of such Delayed Redemptions (the "<u>Subsequent Redeemed Amount</u>") to be satisfied on each subsequent Redemption Date. The Investment Manager intends to liquidate Bitcoin in order to satisfy the portion of the redemption request(s) to be satisfied on a given Redemption Date (including any Subsequent Redeemed Amount designated for redemption on that Redemption Date); *provided*, that, in the Investment Manager's sole discretion, the Investment Manager may use subscription proceeds to satisfy redemption requests in lieu of liquidating Bitcoin. Cash proceeds from such liquidation shall be distributed to Shareholders to satisfy such redemption requests. Shareholders subject to Delayed Redemptions will remain invested in, and therefore still subject to the risks (including the credit, regulatory and operational risks of the exchange on which the Investment Manager sells the Bitcoin to satisfy the redemption requests) of, and liabilities owed to, the Fund.

The Redemption Date with respect to any redemption satisfied through sales of Bitcoin will be the day on which such Bitcoin are sold. For the avoidance of doubt, a Shareholder will be redeemed from the Fund only with respect to the portion of its redemption request that has been satisfied, either through the liquidation of Bitcoin or the offset of subscription proceeds, and shall remain a Shareholder in the Fund with respect to any remaining portion of its investment.

Thus, the TWAP on the date a redemption is requested may differ from the TWAP on the Redemption Date(s).

In the event that the Investment Manager determines to accept an in-kind contribution of Bitcoin from a Shareholder, such Shareholder may request that its redemption request be satisfied in kind up to the lesser of the number of Bitcoin contributed in kind by such Shareholder and the Bitcoin equivalent of the value (on an as-converted to-Bitcoin basis) of such Shareholder's Shares at the time of redemption, and the Fund will make an in-kind distribution in respect of such redemption request; *provided*, that the Fund is not restricted from doing so under applicable law or regulation, that the distribution is made to the same person that made the contribution, and subject to the limitations on redemptions set forth herein.

Suspension

The Investment Manager may suspend the determination of the net asset value of the Fund and the net asset value of each Shareholder's Shares, subscription rights, redemption rights, in whole or in part, and/or the payment of redemption proceeds in respect of voluntary redemptions in any circumstance, including, but not limited to, the following:

(i) during any period when any exchange or over-the-counter market on which the Fund's investments are quoted, traded or dealt in is closed, other than for ordinary holidays and weekends, or during periods in which dealings are restricted or suspended;

(ii) during the existence of any state of affairs as a result of which, in the opinion of the Investment Manager, disposal of the Fund's assets, the payment of redemption proceeds, or the determination of the net asset value per Share, is not reasonably practicable or is reasonably expected to be prejudicial to the non-redeeming Shareholders or the Fund as a whole;

(iii) during the existence of any state of affairs as a result of which disposal of a portion of the Fund's assets is restricted under applicable U.S. or non-U.S. laws or regulations;

(iv) during any breakdown in the means of communication normally employed in determining the price or value of the Fund's assets or liabilities, or of current prices in any financial market as aforesaid, or when for any other reason the prices or values of any assets or liabilities of the Fund cannot reasonably be promptly and accurately ascertained;

(v) during any period when disposal of the Fund's assets, the payment of redemption proceeds, or the determination of the net asset value per Share would cause a breach or default under any covenant in any agreement entered into by the Fund;

(vi) during any period when the Investment Manager has determined that the transfer of funds presents a risk of non-compliance with applicable law or regulation or there is any other issue associated with the transfer of funds; or

(vii) during the period in which the Fund is winding down its business.

The Investment Manager will provide written notice to each affected Shareholder of a suspension of the calculation of net asset value of the Fund or any Shares, redemption rights and/or payment of redemption proceeds or suspensions of subscriptions with respect to investors that have submitted subscriptions for Shares. Upon the determination by the Investment Manager that the condition giving rise to a suspension has ceased to exist and no other condition under which suspension is authorized exists, such suspension will be lifted and written notice will be sent to the affected Shareholders regarding the lifting of such suspension and the next date as of which Shareholders will be permitted to redeem all or a specified percentage of their Shares.

Upon a suspension of redemption rights, all pending redemption requests will retain their priority in order of request, but no requests subsequently received will be accepted until such time as the Investment Manager permits Shareholders to submit redemption requests in anticipation of lifting the suspension.

In addition, the Investment Manager, by written notice to any Shareholder, may suspend or withhold payment of redemption proceeds to such Shareholder if the Investment Manager and/or the

Administrator reasonably deems it necessary to do so to comply with anti-money laundering laws and regulations applicable to the Fund, the Investment Manager, the Administrator or any of the Fund's other service providers.

Soft Wind Down

If the Board of Directors, in consultation with the Investment Manager, decides that the investment program of the Fund is no longer viable, it may resolve that the Fund be managed with the objective of realizing assets in an orderly manner and distributing the proceeds to Shareholders in such manner as they determine to be in the best interests of the Fund, in accordance with the terms of the Articles of Association and this Memorandum, including, without limitation, by compulsorily redeeming Shares, paying any dividend proceeds in specie and/or declaring a suspension while assets are realized. This process is integral to the business of the Fund and may be carried out without recourse to a formal liquidation under the Companies Act or any other applicable bankruptcy or insolvency regime, but will be without prejudice to the right of the Shareholder(s) to place the Fund into liquidation.

Payment of Redemption Proceeds

Subject to the establishment of reserves or holdbacks (as described herein), payment of the amount redeemed generally will be made to a Shareholder without interest and within 10 Business Days of the applicable Redemption Date.

The Investment Manager may, in its sole discretion, make distributions in U.S. dollars or in Bitcoin, or in a combination thereof, in connection with a redemption of Shares by a Shareholder, pursuant to a required redemption, upon wind-down of the Fund, or as necessary for tax, regulatory or other reasons. (See "Certain Risk Factors — Risks Relating to the Structure of the Fund — In-Kind Payments".) The Investment Manager also may, in its sole discretion, make payments in U.S. dollars or in Bitcoin, or in a combination thereof, at any time to all of the Shareholders on a *pro rata* basis.

Required Redemptions

The Investment Manager may, in its sole discretion, compulsorily redeem all or any portion of a Shareholder's Shares at any time, for any reason or no reason, with or without prior notice. The Shareholder receiving such notice will be treated for all purposes and in all respects as a Shareholder who has given notice to redeem such

Shares.

The Investment Manager may, in its sole discretion, modify or waive any or all of the redemption terms with respect to any Shareholder or Tranche.

NET ASSET VALUE CALCULATIONS

The net asset value for purposes of determining subscriptions, redemptions, Management Fees and Realization Fees, will be based on Bitcoin priced at TWAP.

However, the net asset value reported in the Fund's annual audited financial statements will be determined in accordance with U.S. generally accepted accounting principles ("GAAP") and will be calculated based on the price of Bitcoin set by the Exchange representing the principal market, in the Investment Manager's sole discretion, on the last day of each Fiscal Year.

Thus, the net asset value used for purposes of calculating subscription or redemption valuations, Management Fees and Realization Fees and reflected in each Shareholder's net asset value statements may differ from the net asset value reflected in the Fund's annual audited financial statements.

NET ASSET VALUE ADJUSTMENTS

If at any time the Investment Manager determines, in its sole discretion, that a materially incorrect number of Shares was issued to a Shareholder because the net asset value in effect on the date of issuance was incorrect, the Investment Manager will implement such arrangements as it determines, in its sole discretion, are required for an equitable treatment of such Shareholder, which arrangements may include redeeming a portion of such Shareholder's Shares for no additional consideration or issuing new Shares to such Shareholder for no consideration, as appropriate, so that the number of Shares held by such Shareholder following such redemption or issuance, as the case may be, is the number of Shares as would have been issued at the correct net asset value. In addition, if at any time after a redemption of Shares (including in connection with any complete redemption by a Shareholder from the Fund) the Investment Manager determines, in its sole discretion, that the amount paid to such Shareholder or former Shareholder pursuant to such redemption was incorrect (including because the net asset value at which the Shareholder or former Shareholder purchased such Shares or at which the redemption was effected was incorrect), the Fund will pay such Shareholder or former Shareholder any additional amount that it determines such Shareholder or former Shareholder would have been entitled to receive had the redemption been effected at the correct net asset value, or, in its sole discretion, seek payment from such Shareholder or former Shareholder of (and such Shareholder or former Shareholder shall be required to pay) the amount of any excess payment that the Investment Manager determines such Shareholder or former Shareholder received, in each case without interest.

REALIZATION FEES: In consideration of the additional effort expended by the Investment Manager to satisfy redemptions, amounts distributed to Shareholders upon redemption (whether voluntary or compulsory), other than upon dissolution of the Fund, will be reduced by a realization fee ("Realization Fee") equal to 1.0% (with respect to Tranche A Shares). Tranche B Shares are not subject to a Realization Fee. The Investment Manager may, in its sole discretion, reduce or waive the Realization Fee with respect to any Shareholder or Tranche. The Realization Fee may be paid in Bitcoin or in its cash equivalent.

LIMITATIONS ON TRANSFERABILITY: Without the prior written consent of the Board of Directors, which may be withheld in its sole discretion, a Shareholder may not (i) directly, indirectly or synthetically transfer, pledge, assign, hypothecate, sell, convey, exchange, reference under a derivatives contract or any other arrangement or otherwise dispose of or encumber all or any portion of its Shares to any other person (each, a "Transfer"), except by operation of law, or (ii) substitute for itself as a Shareholder any other person. Any attempted Transfer or substitution not made in accordance with the foregoing, to the fullest extent permitted by law, will be void.

MANAGEMENT FEE: The Fund will pay to the Investment Manager a fee for investment management services (the "Management Fee") for each month equal to the aggregate of a daily accrual equal to 0.00205% (0.75% per annum) of the net asset value of Tranche A Shares (before taking into account any Investor-Related Taxes that are accrued but not yet paid as of the applicable calculation date) calculated as of the beginning of each day (including, for the avoidance of doubt, non-Business Days). The Tranche B Shares and Tranche C Shares are not subject to a Management Fee.

The net asset value for purposes of calculating the Management Fee will be based on Bitcoin priced at TWAP for the preceding day.

The Management Fee will be denominated and paid in U.S. dollars, but, to the extent practicable, may be paid to the Investment Manager in Bitcoin.

"Investor-Related Tax" means any tax withheld from the Fund or paid over by the Fund, in each case, directly or indirectly, with respect to or on behalf of a Shareholder or a direct or indirect beneficial owner of the Fund, and interest, penalties and/or any additional amounts with respect thereto, including (i) a tax that is determined based on the status, action or inaction (including the failure of a Shareholder or a direct or indirect beneficial owner of the Fund to provide information to eliminate or reduce withholding or other taxes) of a Shareholder or a direct or indirect beneficial owner of the Fund, or (ii) an "imputed underpayment" within the meaning of Section 6225 of the U.S. Internal Revenue Code of 1986, as amended (the "Internal Revenue Code"), and any other similar tax, attributable to a Shareholder or a direct or indirect beneficial owner of the Fund, as determined by the Board of Directors in its sole discretion.

Payment of the Management Fee will be made upon redemption or within 10 days of the last day of each month.

In the sole discretion of the Investment Manager, the Management Fee may be waived, reduced or calculated differently with respect to the Shares of certain Shareholders, including, without limitation, Shareholders that are members, directors, shareholders, partners, affiliates or employees of the Investment Manager, members of the immediate families of such persons and trusts or other entities for their benefit.

EXPENSES.

Expenses of the Investment Manager

In consideration for the Management Fee, the Investment Manager will provide office space and utilities; quotation and computer equipment; software; certain administrative services; and secretarial, clerical and other personnel to the Fund. The Investment Manager will bear the costs of providing such goods and services, and all of its own overhead costs and expenses.

Expenses of the Fund

The Fund will bear its own expenses including, without limitation, the Management Fee; investment expenses, whether or not such investments are consummated; costs related to the acquisition, disposition, lending and custody of Bitcoin (including, but not limited to, third-party wallet providers); professional fees (including, without limitation, expenses of consultants, investment bankers, attorneys, accountants and other experts) relating to investments and operations of the Fund; fees and expenses relating to software tools, programs or other technology utilized in managing the Fund (including, without limitation, third-party software licensing, implementation, data management and recovery services and custom development costs); costs incurred in attending seminars and conferences related to Bitcoin; research and market data (including, without limitation, any computer hardware and connectivity hardware (*e.g.*, telephone and fiber optic lines) incorporated into the cost of obtaining such research and market data); administrative expenses (including, without limitation, fees and expenses of the Administrator); directors' and officers' (including any AML Officers) fees and expenses; costs related to liability insurance for the Board of Directors; expenses related to any Shareholder meetings; legal expenses; external accounting and valuation expenses (including, without limitation, the cost of accounting software packages); audit and tax preparation expenses; costs related to insuring the Investment Manager and certain of its affiliates against risks related to the management or operation of the Fund; costs of printing and mailing reports and notices; taxes; corporate licensing; regulatory expenses (including, without limitation, filing fees); organizational expenses; expenses incurred in connection with the offering and sale of the Shares and other similar expenses related to the Fund; indemnification expenses; and extraordinary expenses. Generally, Fund expenses, other than the Management Fee and any expenses which the Board of Directors determines in its sole discretion should be allocated to a particular Shareholder or Shareholders (including Investor-Related Taxes), will be charged against the Shares of all the Shareholders on a *pro rata* basis. To the extent that expenses to be borne by the Fund are paid by the Investment Manager, the Fund will reimburse such party for such expenses.

The Investment Manager may, in its sole discretion, purchase insurance to protect the Fund against the loss of Bitcoin if such insurance is available. The cost of such insurance, if any, would be borne by the Fund.

If the Investment Manager appoints an Advisory Committee, such Advisory Committee may approve related party transactions and other matters related to the U.S. Investment Advisers Act of 1940, as amended (the "Advisers Act"), such as a change in control of the Advisor, and its approval of such transactions and matters will be binding on the Shareholders. (See "Certain Risk Factors – Advisory Committee".)

If any of the expenses listed above are incurred for the account of the Fund as well as for any Other Accounts, such expenses will be allocated among the Fund and such Other Accounts in proportion to the size of the investment made by each to which such expense relates, or in such other manner as the Board of Directors considers fair and equitable.

Organizational and Offering Expenses

The Investment Manager may pay or advance to the Fund funds to pay for the Fund's organizational expenses and expenses incurred in connection with the initial offering and sale of the Shares and other similar expenses related to the Fund. The Investment Manager is entitled to reimbursement from the Fund of all such funds.

BORROWING: The Fund may borrow for cash management purposes, such as to execute trades on an Exchange while funds are being transferred to such Exchange. The Investment Manager and any affiliates of the Investment Manager may lend such amounts to the Fund, subject to an aggregate limit of 5% of the Fund's net asset value at the time of borrowing. Any such loans will bear a market interest rate as determined by the Investment Manager, in its sole discretion.

NET ASSET VALUE: The net asset value of a Tranche of Shares will be equal to the excess of the value of the assets over the value of the liabilities attributable to such Tranche as of any date of determination (the "net asset value"). The net asset value per Share of a Tranche is determined by dividing the net asset value of each Tranche by the number of Shares thereof (the "net asset value per Share"). The net asset value of the Fund or a Tranche of Shares will generally be determined daily and at such other times as determined by the Board of Directors.

The net asset value, for purposes of subscriptions and redemptions, will be calculated incorporating Bitcoin priced at TWAP with respect to each Business Day.

Any changes to the number of exchanges used in determining the Bitcoin value must be approved by the Investment Manager. (See "Other Activities of Management; Potential Conflicts of Interest — Valuation.")

Liabilities will be determined by the Investment Manager in a manner it deems to be fair and reasonable, applied on a consistent basis. The Board of Directors in its sole discretion may establish reserves and holdbacks for estimated accrued expenses, liabilities or contingencies, including, without limitation, general reserves and holdbacks for unspecified contingencies and the Investment Manager may establish appropriate reserves upon a redemption by a Shareholder.

FISCAL YEAR: The fiscal year of the Fund (the "Fiscal Year") ends on December 31 of each year.

TAXATION

The Fund intends to operate as a partnership and not as an association (or as a publicly traded partnership) taxable as a corporation for U.S. federal income tax purposes. Accordingly, the Fund does not generally expect to be subject to U.S. federal income tax (other than certain withholding regimes), and each Shareholder will be required to report on its own annual income tax return such Shareholder's distributive share of the Fund's taxable income or loss regardless of whether such Shareholder has received or will receive a distribution from the Fund. As a result, a Shareholder may have a tax liability for any year with respect to "phantom" income from the Fund without receiving a corresponding distribution from the Fund. (See "Tax Aspects")

Cayman Islands Taxation

The Fund is an exempted company under Cayman Islands law. The Fund has received an undertaking from the Governor in Cabinet of the Cayman Islands to the effect that, for a period of 20 years from the date of such undertaking no law which is thereafter enacted in the Cayman Islands imposing any tax to be levied on the profits, income, gains or appreciations shall apply to the Fund or its operations.

ERISA:

Entities subject to the U.S. Employee Retirement Income Security Act of 1974, as amended ("ERISA"), may purchase Shares. Investment in Shares by entities subject to ERISA requires special consideration. Trustees or administrators of such entities are urged to carefully review the matters discussed in this Memorandum. The Fund does not intend to permit investments by Benefit Plan Investors to equal or exceed 25% (or such greater percentage as may be provided in regulations promulgated by the DOL) of the value of any class of equity interests in the Fund. (See "ERISA Considerations".)

For the avoidance of doubt, to comply with the DOL regulations outlined above, the Fund may limit subscriptions by Benefit Plan Investors or redemptions by non-Benefit Plan Investors.

SUITABILITY REQUIREMENTS:

Each Shareholder generally must be either (i) a non-U.S. Person or (ii) a U.S. Person that qualifies as an "accredited investor", as defined in Regulation D under the Securities Act, and either a "qualified purchaser", as defined in the Company Act, or a "knowledgeable employee", as defined under Rule 3c-5 of the Company Act, and must meet other suitability requirements. The Subscription Agreement contains representations and questionnaires relating to these qualifications.

The Board of Directors may, in its sole discretion, decline to accept the subscription of any prospective investor that does not meet such suitability requirements, or for any other reason or for no reason. (See "Suitability Requirements".)

<u>**REPORTS**</u>: Within 120 days after the end of each Fiscal Year or as soon as reasonably practicable thereafter, the Fund will prepare and mail to each Shareholder audited financial statements of the Fund. The Fund will also provide electronically periodic monthly unaudited performance information to the Shareholders.

<u>**SUBSCRIPTION FOR SHARES**</u>: Persons interested in subscribing for Shares will be furnished, and will be required to complete and return to the Administrator, a Subscription Agreement and items relating thereto as outlined in the subscription documents.

<u>**RELATED INVESTMENT VEHICLES**</u> To seek to accommodate or mitigate the legal, tax, regulatory or other investment requirements of certain prospective investors, the Investment Manager may create one or more entities (including vehicles formed to facilitate investment by employees of the Investment Manager or its affiliates) to invest alongside the Fund or one or more entities that will serve as "feeder" entities, including the Feeder Fund, through which investors will indirectly invest in the Fund (each, a "<u>Related Investment Vehicle</u>"), and may establish one or more classes of shares of the Fund or any Related Investment Vehicle in connection therewith. The terms and conditions of an investment in a Related Investment Vehicle will be made available to investors in a separate offering memorandum, or a supplement to this Memorandum, once the Investment Manager has determined to establish such Related Investment Vehicle. To accommodate various tax and regulatory needs of prospective investors, in addition to the Fund, the Investment Manager currently intends to create several Related Investment Vehicles to invest in parallel and/or in partially overlapping investment programs with the Fund.

Without the consent of any Shareholder, the Investment Manager may determine to utilize an alternative structure in which the Fund serves as a "feeder" entity into a "master fund", the Fund will invest substantially all of its assets in such master fund, investments will generally be made by such master fund, and certain fees and expenses currently paid by the Fund (including the Management Fee and Realization Fee) may instead be paid by such master fund; *provided*, that the use of any alternative structure will not result in increased fees being paid to the Investment Manager or its affiliates.

INVESTMENT PROGRAM

The Fund will invest substantially all of its assets in Bitcoin. The Fund will only take immediate delivery of Bitcoin. The Fund will not trade, buy, sell or hold Bitcoin derivatives for any purpose. Transactions in Bitcoin will not be made on a leveraged, margined, or offer-financed basis. Through the investment program, Shareholders in the Fund may indirectly participate in the Bitcoin market without owning or controlling specific Bitcoin. The Fund may engage in Bitcoin lending transactions, in the sole discretion of the Investment Manager.

The Fund's investment program is speculative and entails substantial risks. There can be no assurance that the investment objectives of the Fund will be achieved. (See "Certain Risk Factors".)

MANAGEMENT

The Investment Manager

As discussed above, in its capacity as investment manager of the Fund, the Investment Manager acts solely on behalf of the Fund. The Investment Manager may, in the future, establish feeder funds that invest through the Fund and/or may establish investment vehicles that invest on a *pari passu* basis with the Fund.

Regulatory Status of the Advisor

Pantera Advisors LLC ("Pantera Advisors"), an affiliate of the Investment Manager, is currently registered with the SEC as an investment adviser under the Advisers Act and the Investment Manager is included in Item 7.A. of Pantera Advisors' Form ADV as an "advisory affiliate" of Pantera Advisors. Additional information about the Investment Manager is available on the SEC's website at www.adviserinfo.sec.gov. Registration with the SEC or with any state securities authority does not imply a certain level of skill or training.

Personnel of the Investment Manager

Set forth below is biographical information of the Principal and other personnel of the Investment Manager:

Daniel W. Morehead

Mr. Morehead is the Chief Executive Officer of the Investment Manager. Mr. Morehead founded Pantera Capital Management LP in 2003. He also co-founded and was CEO of Atriax, an electronic foreign exchange platform. Prior to that, he was head of macro trading and CFO at Tiger Management, global head of FX options at Deutsche Bank in London, and managed a global macro fund and derivatives trading units in North America and Japan at Bankers Trust. Mr. Morehead began his career at Goldman Sachs as a mortgage-backed securities trader. He graduated magna cum laude from Princeton University with a B.S. in Civil Engineering and received the Carmichael Prize for an outstanding thesis.

Paul Veradittakit

Mr. Veradittakit is a Partner of the Investment Manager. Prior to joining Pantera in 2014, Mr. Veradittakit worked at Strive Capital as an Associate focusing on investments in the mobile space. Previously, he was at Hatch Consulting and LECG and performed business development and marketing for Urban Spoils, an early stage startup in the daily deal aggregation space. Mr. Veradittakit graduated from the University of California, Berkeley with a B.A. in Psychology and a B.A. in Political Science.

Joey Krug

Mr. Krug is Co-Chief Investment Officer of the Investment Manager and joined in 2017. Prior to joining Pantera, Mr. Krug was Co-Founder and head of core development at Augur.net; built on the Ethereum blockchain, it is the world's first decentralized prediction market. He also serves as a Technical Advisor to Numerai, Tlon and 0x. Mr. Krug attended Pomona College where he studied Computer Science and was a recipient of the Thiel Fellowship.

Matt Gorham

Matt originally joined Pantera in 2005 as a global macro trader and risk analyst. Prior to rejoining Pantera in 2014, he was a portfolio analyst at Aperio Group, a quantitatively-oriented investment firm. He was also an equity trader at LPL Financial Services. Matt earned his B.A. in Economics from the University of California, Berkeley. He holds the Chartered Financial Analyst designation and is a member of the CFA Society of San Francisco.

Investment Management Agreement

The Board of Directors has appointed the Investment Manager pursuant to an investment management agreement with the Fund (the "Investment Management Agreement"), subject to the control of and review by the Board of Directors, *inter alia*, to invest the assets of the Fund in a manner consistent with the investment objective, approach and restrictions described in this Memorandum. Pursuant to the Articles of Association, the Board of Directors has delegated to the Investment Manager its authority to approve or deny subscriptions or redemptions.

The Investment Management Agreement will remain in effect until December 31, of each year, and will automatically renew from year to year thereafter, except that it may be terminated by any party upon at least 90 days' prior written notice by the terminating party to the other party.

Exculpation

The Investment Management Agreement provides that none of the Investment Manager or any of its affiliates or the members, partners, directors, shareholders, officers, employees and legal representatives (*e.g.*, executors, guardians and trustees) of any of them, persons formerly serving in such capacities (each, an "Indemnified Party") will be liable to any Shareholder or the Fund for any costs, losses, claims, damages, liabilities, expenses (including, without limitation, reasonable legal and other professional fees and disbursements), judgments, fines or settlements (collectively, "Indemnified Losses") arising out of, related to or in connection with any act or omission of such Indemnified Party taken, or omitted to be taken, in connection with the Fund or the Investment Management Agreement, except for any Indemnified Losses arising out of, related to or in connection with any act or omission that is found by a court of competent jurisdiction upon entry of a final judgment rendered and unappealable or not timely appealed ("Judicially Determined") to be primarily attributable to the bad faith, gross negligence (as such term is defined under the laws of the State of Delaware, "Gross Negligence"), willful misconduct or actual fraud (as such term is defined under the laws of the State of Delaware, "Fraud") of such Indemnified Party. In addition, no Indemnified Party will be liable to any Shareholder or the Fund for any Indemnified Losses arising out of, related to or in connection with any act or omission taken, or omitted to be taken, by any broker or agent of the Fund if such broker or agent was selected, engaged or retained by such Indemnified Party directly or on behalf of the Fund in accordance with the standard of care set forth above. Any Indemnified Party may consult with counsel, accountants, investment bankers, financial advisers, appraisers and other specialized, reputable, professional consultants in respect of affairs of the Fund and be fully protected and justified in any action or inaction that is taken in accordance with the advice or opinion of such persons; *provided* that such persons will have been selected in accordance with the standard of care set forth above.

Indemnification

The Investment Management Agreement provides that, to the fullest extent permitted by law, the Fund will indemnify and hold harmless each Indemnified Party from and against any and all Indemnified Losses suffered or sustained by such Indemnified Party by reason of any act, omission or alleged act or omission arising out of, related to or in connection with the Fund or the Investment Management Agreement, or any and all claims, demands, actions, suits or proceedings (civil, criminal, administrative or investigative, which includes formal and informal inquiries and "sweep" examinations in connection with the Fund's investment activity), actual or threatened ("Proceedings"), in which an Indemnified Party may be involved, as a party or otherwise, arising out of, related to or in connection with such Indemnified Party's service to or on behalf of, or management of the affairs or assets of, the Fund, or which relate to the Fund, except for any Indemnified Losses that are Judicially Determined to be primarily attributable to the bad faith, Gross Negligence, willful misconduct or Fraud of such Indemnified Party. The Fund will also indemnify and hold harmless each Indemnified Party from and against any and all Indemnified Losses suffered or sustained by such Indemnified Party by reason of any acts, omissions or alleged acts or omissions of any broker or agent of the Fund; *provided* that such broker or agent was selected, engaged or retained by such Indemnified Party directly or on behalf of the Fund in accordance with the standard of care set forth above. The termination of a Proceeding by settlement or upon a plea of *nolo contendere*, or its equivalent, will not, of itself, create a presumption that such Indemnified Party's acts, omissions or alleged acts or omissions were primarily attributable to the bad faith, Gross Negligence, willful misconduct or Fraud of such Indemnified Party. Expenses (including, without limitation, legal and other professional fees and disbursements) incurred in any Proceeding will be paid by the Fund in advance of the final disposition of such Proceeding upon receipt of an undertaking by or on behalf of such Indemnified Party to repay such amount if it will ultimately be determined that such Indemnified Party is not entitled to be indemnified by the Fund.

Notwithstanding any of the foregoing to the contrary, the provisions of the Investment Management Agreement will not be construed so as to provide for the exculpation or indemnification of any Indemnified Party for any liability (including, without limitation, liability under U.S. federal securities laws which, under certain circumstances, impose liability even on persons that act in good faith), to the extent (but only to the extent) that such liability may not be waived, modified or limited under applicable law, but will be construed so as to effectuate such provisions to the fullest extent permitted by law.

To the fullest extent permitted by law, each Shareholder will acknowledge and agree, in its Subscription Agreement, that the Fund will indemnify and hold harmless each Indemnified Party against any and all Indemnified Losses suffered or sustained by reason of any act, omission or alleged act or omission arising out of, related to or in connection with the Fund or any Proceedings in which an Indemnified Party may be involved, as a party or otherwise, arising out of, related to or in connection with the Fund, except for any Indemnified Losses that are Judicially Determined to be primarily attributable to the bad faith, Gross Negligence, willful misconduct or Fraud of such Indemnified Party.

<u>The Board of Directors</u>

As discussed above, the Fund is managed by the Board of Directors. The Directors' business experience are as follows:

Matt Gorham

Mr. Gorham originally joined Pantera in 2005 as a global macro trader and risk analyst. Prior to rejoining Pantera in 2014, he was a portfolio analyst at Aperio Group, a quantitatively-oriented investment firm. He was also an equity trader at LPL Financial Services. Mr. Gorham earned his B.A. in Economics from the University of California, Berkeley. He holds the Chartered Financial Analyst designation and is a member of the CFA Society of San Francisco.

Ryan Davis

Mr. Davis joined Pantera in 2018 as Chief Financial Officer, a role in which he oversees all finance and accounting across the firm's various fund strategies. He previously served as the CFO of Echelon Asset Management, an online marketplace lending platform that manages a half-billion dollars, and as Vice President of Finance at Lightspeed Venture Partners. Mr. Davis began his career in Fund Management and Investor Relations at Bridgewater Associates. He graduated from Cal Poly, San Luis Obispo with a B.A. in Economics.

Scott Lennon

Mr. Lennon is the Managing Director and Principal at 19 Degrees North Fund Services Ltd., a Company Manager regulated by the Cayman Islands Monetary Authority and specialist fiduciary services firm that he founded in December 2011. Mr. Lennon has over 20 years of experience in the global investment funds industry. Prior to founding 19 Degrees North, Mr. Lennon was the Head of Fund Services at Walkers Fund Services Limited, a Cayman Islands licensed Trust Company and Mutual Fund Administrator. Up to 2003, Mr. Lennon was the Head of Investment Fund Services at State Street Cayman Trust Company Ltd. ("<u>State Street</u>"). Prior to joining State Street, in 2001 Mr. Lennon was the Head of Investment Fund Services at Deutsche Bank (Cayman Islands) Ltd. where he led the team that was responsible for the administration of a portfolio of 60 funds with assets in excess of US$7 Billion. Prior to heading Deutsche Bank's Offshore operation in the Cayman Islands in 1997, Mr. Lennon was a Manager in the Alternative Investments Group at KPMG in the Cayman Islands. Prior to Mr. Lennon's arrival in the Cayman Islands in 1997, he resided in Montreal, Canada, where he worked at both KPMG and Deloitte & Touche. Mr. Lennon is a member of the Institute of Chartered Accountants of Ontario (Canada), the American Institute of Certified Public Accountants, and he is a Chartered Financial Analyst charterholder. Mr. Lennon received a Graduate Diploma in Public Accounting from McGill University, Montreal, Canada and a Bachelor of Commerce (Honours) from Carleton University in Ottawa, Canada. Mr. Lennon is an approved Principal with the National Futures Association and he has held appointments on entities that are registered with the Securities and Exchange Commission. Mr. Lennon is a member of the Executive Committee of the Cayman Islands Directors Association and a former member of the Board of Directors of the Cayman Islands Society of Financial Analysts. Mr. Lennon has provided fiduciary services in the investment funds industry for over 10 years and currently holds directorships on a myriad of investment funds covering a wide range of strategies and objectives.

Lisa Volekaert

Lisa Volekaert is a director of 19 Degrees North Fund Services Ltd., a Company Manager regulated by the Cayman Islands Monetary Authority and specialist fiduciary services firm. Lisa has worked in the global investment funds industry for over 25 years.

Prior to joining 19 North FS, Lisa served as Senior Vice President at Walkers Fund Services Limited (acquired by Intertrust), a Cayman Islands licensed Trust Company and Mutual Fund Administrator. During her tenure at Walkers Fund Services Limited, Lisa held directorships on investment funds and other vehicles covering a broad range of investment strategies and platforms.

Lisa was the Chief Financial Officer for Accelerated Capital Investments Ltd., a family owned investor and public relations company in Ontario, Canada before joining Walkers Fund Services Limited in 2006.

Prior to her position at Accelerated Capital Investments Ltd., Lisa was Vice President and Senior Account Manager, Global Fund Services, at the Bank of Bermuda Ltd. (HSBC Group) in Hamilton, Bermuda. There, Lisa was instrumental in building and managing strategic relationships for a number of significant mutual and hedge fund clients. In this role, she led a team that was responsible for the accurate and timely delivery of full fund administration services to a variety of convertible, private equity, hedge and fund-of-fund clients.

Lisa also has significant risk-based audit and tax experience. While at the Bank of Bermuda Ltd., Lisa was responsible for conducting risk-based financial and operational audits covering all departments within the Bank, both locally and internationally. Additionally, prior to joining the Bank of Bermuda Ltd. in 1997, Lisa worked at Deloitte in Ontario, Canada for 8 years where she held various audit and tax roles, including that of Tax Manager.

Lisa is a member of the Chartered Professional Accountants of Ontario (formerly The Institute of Chartered Accountants of Ontario, Canada), a Chartered Financial Analyst (CFA) charterholder, a member of the CFA Institute, and a member of the Cayman Islands Directors Association. Lisa received a Bachelor of Business Administration degree (with Co-op Accounting Option) (with Honours) from Brock University in Ontario, Canada.

Having worked in Bermuda and the Cayman Islands for nearly 20 years collectively, Lisa has gained extensive experience in the offshore financial industry, a comprehensive understanding of the markets and a command of varying types of hedge fund strategies. Lisa applies this valuable experience and jurisdictional knowledge to her current portfolio of directorships.

Glenn Kennedy

Glenn Kennedy is the founder of Leeward Management Limited. He serves as an advisor to, and independent board member of Cayman Islands investment funds and their managers. In these roles, his focus is on corporate governance and legal and compliance matters, bringing over 20 years' experience with fund formation, operations, regulatory and business law to his client boards.

Mr. Kennedy previously served as General Counsel of a listed European fund management group, during which time he implemented an innovative, first-of-its-kind restructuring of a group of distressed Cayman Islands hedge funds, pioneering a restructuring model which was later adopted by many distressed funds during the 2008-09 financial crisis. He subsequently served as a special advisor to an investor's committee on value recovery related matters.

Previously, Mr. Kennedy was an associate attorney with the Cayman Islands office of a multi-jurisdictional offshore law firm as part of the firm's investment funds team, and was prior to that an equity partner with a Toronto, Canada based business law firm, where he practiced in the areas of corporate law and investment funds.

Mr. Kennedy holds Bachelor of Laws and Bachelor of Arts degrees from the University of Manitoba, Canada. Glenn is a Professional Director registered pursuant to the Directors Registration and Licensing Law, 2014. He holds Canadian, United Kingdom and British Overseas Territories citizenship, and is a permanent resident of the Cayman Islands.

The Fund reimburses the Directors for expenses incurred in the performance of their duties (including, without limitation, reasonable traveling, hotel and other related expenses properly incurred in attending meetings held in connection with the business of the Fund).

The Articles of Association contain provisions for the limitation of liability and the indemnification out of the assets of the Fund of the Fund's Directors and officers (and other persons), in the absence of willful default or actual fraud by the Directors or officer, to the extent permitted by law, against any loss, cost, expense or liability incurred by any Director or officer by reason of such Director or officer being or having been such a Director or officer. Further provisions regarding the Directors are included in the Articles of Association.

The Directors may appoint alternates who may attend Board meetings in their absence. The Board of Directors may delegate ordinary course decisions to the Investment Manager (*e.g.*, lowering the minimum subscription amount (subject to the absolute minimum set out herein), allowing revocation of any redemption request, waiving the notice requirement for a redemption, permitting transfers of Shares and rejecting subscriptions).

Mail addressed to the Fund and received at its registered office will be forwarded unopened to the forwarding address supplied by the Fund to be dealt with. None of the Fund, its directors, officers, advisers or service providers (including the organization which provides registered office services in the Cayman Islands) will bear any responsibility for any delay howsoever caused in mail reaching the forwarding address. In particular the Directors will only receive, open or deal directly with mail which is addressed to them personally (as opposed to mail which is addressed just to the Fund).

CERTAIN RISK FACTORS

Prospective Shareholders should carefully consider the risks involved in an investment in the Fund, including, without limitation, those discussed below. Additional or new risks not addressed below may affect the Fund. The following list of risk factors cannot be and is not intended to be exhaustive. Prospective Shareholders should consult their own legal, tax and financial advisers about the risks of an investment in the Fund. The following risk factors and other relevant risks could have a material adverse effect on the Fund and the Shareholders' investments therein.

Risks Relating to Private Investment Funds Generally

Legal and Regulatory Environment for Private Investment Funds and their Managers. The legal, tax and regulatory environment worldwide for private investment funds (such as the Fund) and their managers is evolving, and changes in the regulation of private investment funds, their managers, and their trading and investing activities may have a material adverse effect on the ability of the Fund to pursue its investment program and the value of investments held by the Fund. There has been an increase in scrutiny of the alternative investment industry by governmental agencies and self-regulatory organizations. New laws and regulations or actions taken by regulators that restrict the ability of the Fund to pursue its investment program or employ counterparties or service providers (e.g., Bitcoin custodians) could have a material adverse effect on the Fund and the Shareholders' investments therein.

Alternative Investment Fund Managers Directive. The Alternative Investment Fund Managers Directive (the "AIFM Directive") regulates: (i) alternative investment fund managers (each, an "AIFM") based in the European Economic Area (the "EEA") or the United Kingdom (the "UK"); (ii) the management of any alternative investment fund ("AIF") established in the EEA or the UK (irrespective of where an AIF's AIFM is based); and (iii) the marketing of any AIF, such as the Fund, to professional investors in the EEA or the UK.

Under the AIFM Directive, certain conditions must be met to permit the marketing of the Shares to any potential and existing investors in the EEA or the UK. The ability of the Fund or the Investment Manager to offer the Shares in the EEA or the UK will depend on the relevant state permitting the marketing of non-EEA or UK domiciled funds under the national private placement regimes implementing the AIFM Directive and the ability of the Fund and the Investment Manager to comply with such national private placement regimes, where available. Compliance with the requirements of such regimes may increase the costs of the administration of the Fund significantly, including the costs of regulatory reporting, custody and other services provided to the Fund. As such, the Fund's ability to market the Shares to EEA or UK investors may be limited.

Systemic Risk. Systemic risk is the risk of broad financial system stress or collapse triggered by the default of one or more financial institutions, which results in a series of defaults by other interdependent financial institutions. Financial intermediaries, such as clearinghouses, banks, securities firms and exchanges with which the Fund interacts, as well as the Fund, are all subject to systemic risk. A systemic failure could have material adverse consequences on the Fund and on the markets in which the Fund seeks to invest. The Fund's investment program, which focuses on Bitcoin, involves new types of financial intermediaries the systemic risk of which may be less correlated to broader markets.

Historical Liabilities of the Fund. From 2004 to 2008, the Fund made investments by employing a macroeconomic, fundamental strategy to invest in foreign exchange positions on behalf of third-party investors. From 2008 to June 2013, the Fund ceased to make investments on behalf of third-party investors, and made investments in forex and other assets on behalf of the Principal. The Fund may be subject to liabilities from these prior activities, regardless of whether the liabilities are related to the Fund's current investment strategy.

Recourse to the Fund's Assets. The Fund's assets, including any investments made by the Fund and any capital held by the Fund, are available to satisfy all liabilities and other obligations of the Fund, including any historical liabilities of the Fund existing prior to the commencement of the Fund's Bitcoin investment strategy. If the Fund becomes subject to a liability, parties seeking to have the liability satisfied may have recourse to the Fund's assets generally and may not be limited to any particular asset, such as the investment giving rise to the liability.

Risks Relating to Management

Limited Operating History. Each of the Fund and the Investment Manager has a limited operating history upon which current and prospective Shareholders can evaluate their anticipated performance.

Dependence on the Investment Manager. The success of the Fund is dependent upon the ability of the Investment Manager to manage the Fund and effectively implement the Fund's investment program. The Fund's governing documents do not permit the Shareholders to participate in the management and affairs of the Fund. If the Investment Manager were to lose the services of the Principal or the Fund or any of the Other Accounts managed by the Investment Manager were to incur substantial losses, the Investment Manager might not be able to provide the same level of service to the Fund as it has in the past or continue operations. The loss of the services of the Investment Manager could have a material adverse effect on the Fund and the Shareholders' investments therein.

Dependence on Counterparties and Service Providers. The Fund is also dependent upon its counterparties (including Bitcoin custodians, wallet providers and exchanges) and the businesses that are not controlled by the Investment Manager that provide services to the Fund (the "Service Providers"). Errors are inherent in the business and operations of any business, and although the Investment Manager will adopt measures to prevent and detect errors by, and misconduct of, counterparties and Service Providers, and transact with counterparties and Service Providers it believes to be reliable, such measures may not be effective in all cases. In particular, the Fund's technology diligence on certain Bitcoin counterparties may not identify all security vulnerabilities and risks, which is especially pertinent given the limited (but growing) number of viable Bitcoin counterparties. Any errors or misconduct could have a material adverse effect on the Fund and the Shareholders' investments therein.

As the Fund has no employees, the Fund is reliant on the performance of the Service Providers. Each Shareholder's relationship in respect of its Shares is with the Fund only. Accordingly, absent a direct contractual relationship between the investor and the relevant Service Provider, no Shareholder will have any contractual claim against any Service Provider for any reason related to its services to the Fund. Instead, the proper plaintiff in an action in respect of which a wrongdoing is alleged to have been committed against the Fund by the relevant Service Provider is, prima facie, the Fund.

Retention and Motivation of Key Employees. The success of the Fund is dependent upon the talents and efforts of highly skilled individuals employed by affiliates of the Investment Manager and such affiliates of the Investment Manager's ability to identify and willingness to provide acceptable compensation to attract, retain and motivate talented investment professionals and other employees. There can be no assurance that the affiliates of the Investment Manager's investment professionals will continue to be associated with the Investment Manager throughout the life of the Fund, and the failure to attract or retain such investment professionals could have a material adverse effect on the Fund and the Shareholders' investments therein. Competition in the financial services industry for qualified employees (especially in the intersection of technology and finance) is intense and there is no guarantee that, if lost, the talents of the affiliates of the Investment Manager's investment professionals could be replaced.

Misconduct of Employees and Service Providers. Misconduct by employees of the Investment Manager or its affiliates or by Service Providers to the Fund could cause significant losses to the Fund. Employee misconduct may include binding the Fund to transactions that present unacceptable risks and unauthorized activities, concealing unsuccessful activities (which, in either case, may result in unknown and unmanaged risks or losses) and misappropriating Bitcoin. Losses could also result from actions by Service Providers, including failing to record transactions or improperly performing custodial, administrative and other responsibilities. In addition, employees and Service Providers may improperly use or disclose confidential information, which could result in litigation or serious financial harm, including the loss of Bitcoin. There can be no assurance that the measures that the Fund, the Investment Manager and their affiliates expect to implement to prevent and detect employee misconduct and to select reliable third-party service providers will be effective in all cases.

Increased Regulatory Oversight. Increased regulation (whether promulgated under securities laws or any other applicable law) and regulatory oversight of, and changes in law applicable to, private investment funds and their managers, especially with respect to private investment funds investing in cryptocurrencies (such as the Fund) and their managers (such as the Investment Manager), may impose administrative burdens on the Investment Manager, including, without limitation, responding to examinations and other regulatory inquiries and implementing policies and procedures. Such administrative burdens may divert the Investment Manager's time, attention and resources from portfolio management activities to responding to inquiries, examinations and enforcement actions (or threats thereof). Regulatory inquiries often are confidential in nature, may involve a review of an individual's or a firm's activities or may involve studies of the industry or industry practices, as well as the practices of a particular institution.

Effect of Substantial Losses or Redemptions. If, due to extraordinary market conditions or other reasons, the Fund and other private investment funds managed by the Investment Manager were to incur substantial losses or were subject to an unusually high level of redemptions, the revenues of the Investment Manager may decline substantially. Such losses and/or redemptions may hamper the Investment Manager's ability to (i) retain employees, (ii) provide the same level of service to the Fund as it has in the past, and (iii) continue operations. In the event that redemptions are delayed, the pricing of redemption proceeds may be set for a portion of the Delayed Redemption, while the other portion may remain in the Fund and continue to be at risk.

Risks Relating to the Structure of the Fund

Significant Fees and Expenses. The fees and expenses of the Fund may be significant. The Fund must generate sufficient income to offset such fees and expenses to avoid a decrease in the net asset value of the Fund.

Absence of Regulatory Oversight. The Fund and the Shares are not expected to be registered under the securities laws of the United States or any other jurisdiction other than the Cayman Islands. In particular, the Fund will not be registered as an investment company under the Company Act, and, therefore, will not be required to adhere to the restrictions and requirements under the Company Act. Accordingly, the provisions of the Company Act (which, among other things, require investment companies to have a majority of disinterested directors, require securities to be held in custody by a bank or broker in accordance with rules requiring the segregation of securities, prohibit the investment companies from engaging in certain transactions with its affiliates and regulate the relationship between advisers and investment companies) are not applicable.

The Fund is regulated as a mutual fund under the Mutual Funds Act. However, registration under the Mutual Funds Act does not involve an examination of the merits of the Fund or supervision of the investment performance of the Fund by the Cayman Islands government or the Monetary Authority. There is no financial obligation or compensation scheme imposed on or by the government of the Cayman Islands in favor of or available to the investors in the Fund.

Payment of Redemption Proceeds to Shareholders Based on Unaudited Data. The calculation and payment of a Shareholder's redemption proceeds may be based on estimated and unaudited data. Accordingly, adjustments and revisions may be made to the Fund's net asset value following the year-end audit of the Fund. The Fund will not make any revision to a Shareholder's redemption proceeds based upon audit adjustments. Thus, the Fund will not seek reimbursement in the event of any overpayment and will not pay additional amounts in the event of an underpayment.

Indemnification and Exculpation. The Fund will indemnify certain persons as described under "Indemnification" above. Although Investors will not be individually obligated with respect to such indemnification beyond the amount of their investments or any distributions thereon, such liabilities may be material and may have an adverse effect on the returns to the Investors. Furthermore, the Fund's governing documents limit the circumstances under which Indemnified Parties may be held liable to the Fund or the Investors. As a result, the Fund and the Investors may have a more limited right of action in certain cases than they would in the absence of such a limitation.

Timing of Admission to the Fund. Some of the transactions in which the Fund will engage will be consummated in global markets. In some cases, funds transmitted from the Fund's subscription accounts to counterparties in a non-US market may not arrive on the same Business Day. An investor will be deemed to be a Shareholder of the Fund when all or a portion of its subscription amount leaves the Fund's subscription account, but the net asset value of such Shareholder's Shares will be determined on the earlier of the day its subscription amount arrives at such counterparty and two Business Days after it left the subscription account.

Redemptions by the Investment Manager and its Affiliates. The Investment Manager or its affiliates, principals and employees may, from time to time, have significant investments in the Fund. There are no restrictions on the ability of such persons to redeem their Shares in the Fund, beyond those applicable to other Shareholders. In the event that the Investment Manager and its affiliates and employees redeem their interests in the Fund, other Shareholders in the Fund would not receive notice of such redemptions (either before or after redemption). Such redemptions may accelerate the realization of taxable income and/or gains to Shareholders, in each case to the extent that the Fund is required to sell investments at times when it would not otherwise do so. (See also "Certain Material U.S. Federal and State Income Tax Consequences.")

Activities of and Benefits to the Principal. The Principal and his affiliates have in the past and intend in the future to invest in companies and businesses in the digital currency industry. The Fund's activities are generally expected to create value for, and otherwise facilitate, other activities of the Principal in the digital currency industry. The Fund and its Shareholders will not share in any such benefit. Except as required by law, the Principal and his affiliates will not seek approval from the Fund prior to engaging in such investments. (*See* "Other Activities of Management; Potential Conflicts of Interest".)

In addition, the Principal and/or his principals, employees or affiliates may trade in Bitcoin and/or other alternative currencies outside of the Fund, which may conflict or compete with the Fund, including by buying or selling Bitcoin when the Fund is doing the opposite.

Advisory Committee. The Fund, in the Investment Manager's discretion, may establish an advisory committee, composed of representatives of certain Shareholders (the "Advisory Committee"), to review certain matters in respect of the Fund and decisions of the Investment Manager, including certain potential conflicts of interest referred to it by the

Investment Manager, and certain matters under the Advisers Act. The Advisory Committee will act by majority vote.

Certain transactions that involve conflicts of interest, including principal trades, may be submitted to the Advisory Committee. However, the Advisory Committee will not necessarily represent the interests of all the Shareholders and the members of the Advisory Committee may themselves be subject to various conflicts of interest (including as investors in other entities related to or advised by the Investment Manager). In general, the Shareholders will not be entitled to control the selection of Advisory Committee members or to review the actions or deliberations of the Advisory Committee. In addition, Advisory Committee members have no fiduciary obligations to the Fund or its Shareholders other than to act in good faith and, therefore, Advisory Committee members may take into consideration their own interests in a particular matter and are not required to take into consideration the interests of the Fund or any of the other Shareholders.

Limited Liquidity. Though the Fund generally has daily liquidity, an investment in the Fund may have limited liquidity in certain circumstances, including when a Shareholder's redemption request is delayed (e.g., due to any lending of Bitcoin by the Fund) or during a suspension of the Fund's redemption rights, as described herein. If the Investment Manager is unable to sell sufficient Bitcoin to satisfy a redemption request, a Shareholder's redemption request may remain in the Fund for an extended period of time.

In-Kind Payments. Although the Fund intends to pay redemptions in U.S. dollars (*i.e.*, fiat currency), the Investment Manager may, in its sole discretion, determine to pay redemptions in Bitcoin (in whole or in part) if the Investment Manager determines that doing so is in the best interests of the Fund, or addresses a specific Fund need. There can be no assurance that the Fund will have sufficient cash (or Bitcoin) to satisfy redemption requests, or that it will be able to liquidate investments at favorable prices at the time such redemptions are requested. Investments distributed in kind may include interests in special purpose vehicles established by the Fund for tax, regulatory or other reasons. The risk of loss and delay and expense relating to liquidating or transferring these securities will be borne by such Shareholders, with the result that such Shareholders may receive less cash than they would have otherwise received on the date of redemptions. Shareholders have no right to request in-kind distributions, and should not expect the Fund to accommodate any such request. Notwithstanding the foregoing, in the event that the Investment Manager determines to accept an in-kind contribution of Bitcoin from a Shareholder, such Shareholder may request that its redemption request be satisfied in-kind and the Fund will make an in-kind distribution in respect of such redemption request; *provided*, that the Fund is not restricted from doing so under applicable law or regulation, that the distribution is made to the same person that made the contribution, and subject to the limitations on redemptions set forth herein.

Risks Relating to the Operations and Investment Activities of the Fund

Systems and Operational Risks. The Fund depends on the Investment Manager to develop and implement appropriate systems for the Fund's activities. The Fund relies heavily and on a daily basis on financial, accounting and other data processing systems to execute, clear and settle transactions, to monitor its portfolio and capital, and to generate risk management and other reports that are critical to oversight of the Fund's activities. In addition, the Fund relies on information systems to store sensitive information about the Fund, the Investment Manager, their affiliates and the Shareholders. Certain of the Fund's and the Investment Manager's activities will be dependent upon systems operated by third parties, including the Administrator, third-party wallet provider, market counterparties and other service providers, and the Investment Manager may not be in a position to verify the risks or reliability of such third-party systems. Failures in the systems employed by the Investment Manager, the Administrator, counterparties, exchanges and similar clearance and settlement facilities and other parties could result in mistakes made in the confirmation or settlement of transactions, or in transactions not being properly booked, evaluated or accounted for. In addition, despite the security measures established by the Investment Manager and third parties to safeguard the information in these systems, such systems may be vulnerable to attacks by hackers or breached due to employee error, malfeasance or other disruptions. Any such breach could compromise these systems and result in the theft, loss or public dissemination of the information stored therein. Disruptions in the Fund's operations or breach of the Fund's information systems may cause the Fund to suffer, among other things, financial loss, the disruption of its business, liability to third parties, regulatory intervention or reputational damage. Any of the foregoing failures or disruptions could have a material adverse effect on the Fund and the Shareholders' investments therein.

Cybersecurity Risk. As part of its business, the Investment Manager processes, stores and transmits large amounts of electronic information, including information relating to the transactions of the Fund and personally identifiable information of the Shareholders. Similarly, Service Providers of the Investment Manager, the Fund, especially the Administrator, may process, store and transmit such information. The Investment Manager has procedures and systems in place that it believes are reasonably designed to protect such information and prevent data loss and security breaches. However, such measures cannot provide absolute security. The techniques used to obtain unauthorized access to data, disable or degrade service, or sabotage systems change frequently and may be difficult to detect for long periods of time. Hardware or software acquired from third parties may contain defects in design or manufacture or other problems that could unexpectedly compromise information security. Network connected services provided by third parties to the Investment Manager may be susceptible to compromise, leading to a breach of the Investment Manager's network. The Investment Manager's systems or facilities may be susceptible to employee error or malfeasance, government surveillance, or other security threats. On-line services provided by the Investment Manager to the Shareholders may also be susceptible to compromise. Breach of the Investment Manager's information systems may cause information relating to the transactions of the Fund and personally identifiable information of the Shareholders to be lost or improperly accessed, used or disclosed.

The Service Providers of the Investment Manager, the Fund are subject to the same electronic information security threats as the Investment Manager. If Service Providers fail to adopt or adhere to adequate data security policies, or in the event of a breach of its networks, information relating to the transactions of the Fund and personally identifiable information of the Shareholders may be lost or improperly accessed, used or disclosed.

The loss or improper access, use or disclosure of the Investment Manager's or the Fund's proprietary information may cause the Investment Manager or the Fund to suffer, among other things, financial loss, the disruption of its business, liability to third parties, regulatory intervention or reputational damage. Any of the foregoing events could have a material adverse effect on the Fund and the Shareholders' investments therein.

Audits of Cryptocurrency Funds. Audits for investment funds holding cryptocurrencies are unlike audits for other types of investment funds. Special procedures must be taken to assess whether investments and transactions are properly accounted for and valued because independent confirmation of cryptocurrency ownership (e.g., ownership of a balance on a cryptocurrency exchange) differs dramatically from traditional confirmation with a securities broker or bank account. The Fund, the Investment Manager and the Administrator will need to have satisfactory processes in place in order for the Auditor to obtain the Fund's transaction history and properly prepare audited financials. Any breakdown in such processes may result in delays or other impediments of an audit. In addition, the complexity of cryptocurrencies generally may lead to difficulties in connection with the preparation of the Fund's audited financials.

Macroeconomic Factors; Assumption of Catastrophe Risks. The performance of the Fund's investments could be adversely affected by macroeconomic factors. Such macroeconomic factors include incidents of terrorism and similar events and recent and proposed changes to laws and regulations affecting the cryptocurrency and financial industry. The performance of the Fund's investments could also be adversely affected by various catastrophic events, including the following: hurricanes, earthquakes and other natural disasters; war, terrorism and other armed conflicts; cyberterrorism; major or prolonged power outages or network interruptions; and public health crises, including infectious disease outbreaks, epidemics and pandemics.

Coronavirus Risks. In December 2019, the virus SARS-CoV-2, which causes the coronavirus disease known as COVID-19, surfaced in Wuhan, China. The disease spread around the world, resulting in the temporary closure of many corporate offices, retail stores, and manufacturing facilities across the globe, as well as the implementation of travel restrictions and remote working and "shelter-in-place" or similar policies by numerous companies and national and local governments. These actions caused the disruption of manufacturing supply chains and consumer demand in certain economic sectors, resulting in significant disruptions in local and global economies. The short-term and long-term impact of COVID-19 on the operations of the Investment Manager and the performance of the Fund is difficult to predict. Any potential impact on such operations and performance will depend to a large extent on future developments and actions taken by authorities and other entities to contain COVID-19 and its economic impact. These potential impacts, while uncertain, could adversely affect the performance of the Fund.

Identity and Reporting of Beneficial Ownership; Withholding on Certain Payments. In order to avoid a U.S. withholding tax of 30% on certain payments (which might in the future include payments of gross proceeds) made with respect to certain actual and deemed U.S. investments, the Fund has registered with the Service and generally will be required to identify, and report information with respect to, certain direct and indirect U.S. account holders (including debtholders and equityholders). The Cayman Islands has signed a Model 1B (non-reciprocal) inter-governmental agreement with the United States (the "US IGA") to give effect to the foregoing withholding and reporting rules. So long as the Fund complies with the US IGA and the enabling Cayman Islands legislation, it will not be subject to the related U.S. withholding tax.

A non-U.S. investor in the Fund will generally be required to provide to the Fund information which identifies its direct and indirect U.S. ownership. Under the US IGA, any such information provided to the Fund and certain financial information related to such investor's investment in the Fund will be shared with the Cayman Islands Tax Information Authority or its delegate (the "Cayman TIA"). The Cayman TIA will exchange the information reported to it with the Service annually on an automatic basis. A non-U.S. investor that is a "foreign financial institution" within the meaning of Section 1471(d)(4) of the IRC will generally be required to timely register with the Service and agree to identify, and report information with respect to, certain of its own direct and indirect U.S. account holders (including debtholders and equityholders). A non-U.S. investor who fails to provide such information to the Fund or timely register and identify, or report information with respect to, such account holders (as applicable) may be subject to the 30% withholding tax with respect to its share of any such payments attributable to actual and deemed U.S. investments of the Fund, and the Fund or its agents may take any action in relation to an investor's Shares or redemption proceeds to ensure that such withholding is economically borne by the relevant investor whose failure to provide the necessary information or comply with such requirements gave rise to the withholding. Shareholders should consult their own tax advisors regarding the possible implications of these rules on their investments in the Fund.

Governmental Entity Investors. Governmental entities, including pension plans maintained by governmental agencies and instrumentalities, may invest in the Fund. Such investors may be subject to laws that affect the applicability or enforcement of certain terms generally governing the Fund. For example, exculpation, indemnification, confidentiality, choice of law and choice of venue provisions may be applied differently with respect to such investors. In addition, investment in the Fund by certain governmental entities may subject the Fund and/or the Investment Manager to increased regulatory burdens and public disclosures about the Fund, its investors and its activities.

Risks Relating to Investment Strategy

Single Purpose. Other than cash held for working capital purposes, the Fund will invest solely in Bitcoin (any may engage in Bitcoin lending transactions), which is a highly speculative asset. The Bitcoin held by the Fund are commingled and investors have no specific rights to any specific Bitcoin. In the event of the Fund's insolvency, its assets may be inadequate to satisfy a claim by the Fund or an investor. The timing of the Fund's acquisition and disposition of Bitcoin will be affected by the timing of subscriptions and redemptions. The Fund will not take any steps to minimize volatility or manage risk. No guarantee or representation is made that the Fund's investment program will be successful. Bitcoin are extremely volatile and investment results may vary substantially over time. ***No assurance can be made that profits will be achieved or that substantial or complete losses will not be incurred.*** *Past investment results of the Investment Manager (or investments otherwise made by the investment professionals of the Investment Manager) are not necessarily indicative of their future performance.*

Risk of Total Loss of Capital. While all investments risk the loss of capital, investments in Bitcoin should be considered substantially more speculative and significantly more likely to result in a total loss of capital than most other investment funds. The Investment Manager will not attempt to mitigate the potential of loss of capital through the use of risk management techniques. Rather, the Investment Manager generally intends only to sell Bitcoin when such sales are necessary in order to satisfy shareholder redemption requests. Furthermore, the Investment Manager does not intend to hedge potential losses and will not make investment decisions based on the price of Bitcoin. Consequently, an investment in the Fund could result in the total loss of a Shareholder's capital.

Bitcoin Generally. The investment characteristics of virtual cryptocurrency generally, and of bitcoin ("Bitcoin" or "BTC") specifically, differ from those of traditional currencies, commodities or securities. Importantly, Bitcoin is not backed by a central bank or a national, supra-national or quasi-national organization, any hard assets, human capital, or other form of credit. Rather, it is market-based: Bitcoin's value is determined by (and fluctuates often, according to) supply and demand factors, the number of merchants that accept it, and the value that various market participants place on it through their mutual agreement, barter or transactions.

Overview of Bitcoin, the Bitcoin Network and the Bitcoin Market. Presently, Bitcoin is a type of decentralized, virtual "cryptocurrency," that functions without the intermediation of any central authority. Each individual Bitcoin unit exists as a digital file, based upon a mathematical proof, and is comprised of two numbers, or "keys": the public key that encrypts a transaction value and the private key that decrypts it. Bitcoin allows users to send payments within a decentralized, peer-to-peer network, and does not require a central clearing house or financial institution clearing transactions. The smallest unit into which a Bitcoin can be divided is called the Satoshi: 1 Bitcoin contains 100 million Satoshi.

Bitcoin network. The "Bitcoin network" refers to the online platform through which Bitcoin is mined, validated and transmitted. Understanding the Bitcoin network requires an understanding of the terms "cryptography," "blockchain" and "mining."

Cryptography. In the Bitcoin context, cryptography refers to the mathematical proofs on which any given Bitcoin is based. The cryptography basis is intended to provide the Bitcoin network a high level of security. Such security, in turn, is designed to permit network users to control transactions and prevent double-spending (*i.e.*, when a unit of Bitcoin would be concurrently sent to and accepted by two different recipients). The Bitcoin network hosts (provides a forum for) the blockchain. As explained below, the blockchain and "mining" concepts are necessary to create a consensus on the network about which transactions will be confirmed and considered valid.

Blockchain. The blockchain is a chronologically ordered, public record of all validated Bitcoin transactions across the Bitcoin network. It is shared among all Bitcoin users. Each "block" in the "chain" (or entry in the record) contains and confirms many waiting transactions.

The blockchain works as follows: Engaging in Bitcoin transactions requires a user to install or access on its computer or mobile device a Bitcoin software program that will allow the user to generate a digital Bitcoin account—commonly known as a "digital wallet" or "wallet"—in which to store Bitcoin, connect to the Bitcoin network, and purchase or sell, own, transfer, or receive Bitcoin. Users that have installed available Bitcoin-Qt must also make periodic software upgrades. Each Bitcoin wallet includes a unique address and verification system consisting of a "public key" and a "private key" which are linked mathematically to each other. A public key serves as an address for the digital wallet—similar to a bank account number. A user must provide its public key to the party initiating the transfer. The private key is a secret piece of data that proves the user is authorized to spend Bitcoin from a specific wallet—similar to a personal pin to confirm a transaction. It authorizes access to, and transfer of, the funds in the digital wallet to other users. Private key(s) may be stored on a user's computer or on remote servers. If a user fails to secure or make a backup of the public and private key relating to a digital wallet, or loses its private key, or the digital wallet containing the keys is deleted or hacked into, the user permanently loses access to the Bitcoin contained in the associated digital wallet, without any recourse to a centralized group or agency to assist in its recovery.

Each Bitcoin user must "sign" transactions with a data code derived from entering the applicable private key into a "hashtag algorithm." The hashtag algorithm produces a hash (or timestamp) which serves as a signature validation that the transaction has been authorized by the Bitcoin owner. Each timestamp includes the previous timestamp hash as input for its own hash. This dependency of one hash on another is what forms a chain, with each additional timestamp providing evidence that each of the previous timestamp hashes existed. Presently, each block on the blockchain contains a record of hundreds of validated transactions. Each validated transaction contains a unique identifier (*i.e.*, a Bitcoin address/public key) that can be searched and located on the blockchain through Web sites like www.blockchain.com. It takes approximately ten minutes for each Bitcoin transaction to be confirmed by the network through the efforts of miners and a new block in the blockchain to be created. Each block that is added to the blockchain reduces the risk that a previous transaction will not be reversed or that double spending has not occurred.

Mining. Bitcoin mining is the process of validating and adding transaction records to Bitcoin's public ledger of past transactions (*i.e.,* the blockchain). Each block is an independent mathematical proof which depends on the previous block. As an incentive to update the blockchain, Bitcoin miners may collect transaction fees for the transactions they confirm, along with newly created Bitcoin (*i.e.,* rewards). Only the first miner to compute the proof is rewarded with Bitcoin, while the rest of the miners have to start over on a new block. Bitcoin supply is increased with every new block of transactions that is added to the blockchain. Currently, the reward is six and a quarter (6.25) Bitcoin for each block that is added to the blockchain. The reward for solving a block is automatically adjusted—reduced by half for every 210,000 blocks mined—so that roughly every four years of operation of the Bitcoin network, half the amount of Bitcoin created in the prior four years are created. It is understood (but not guaranteed) that the total number of Bitcoin in existence will never exceed 21 million. Mining is currently very expensive and time-consuming, and miners must dedicate substantial resources to continuously power and cool devices. The mining reward system is designed to ensure that miners are compensated for their efforts and new Bitcoin enters into public circulation. The Bitcoin network's mining protocol is intended to make it more difficult to solve for new blocks in the blockchain as the processing power dedicated to mining increases. Therefore, the Bitcoin mining process is designed to incentivize people to be efficient and use as little power as possible to create blocks and validate the transactions. Given the time and resources that must be dedicated to mining, miners may "pool" their efforts and act cohesively to combine their processing power to solve blocks. These efforts are called mining "pools"—and pool members generally split any resulting rewards based on the processing power they each contributed to solve for such blocks.

Virtual Currency Exchanges. Virtual currency exchanges are third-party service providers that convert Bitcoin to fiat currencies (*i.e.*, currency a government considers to be legal tender) or other virtual currencies. Bitcoin are bought, sold, and traded with publicly disclosed (but often-changing) valuations on virtual currency exchanges, where the majority of Bitcoin buying and selling activity occurs. Virtual currency exchanges provide the most data with respect to prevailing valuations of Bitcoin. Market participants can choose which exchange on which to buy or sell Bitcoin, although these exchanges may charge significant fees for processing transactions. A virtual currency exchange is subject to U.S. federal and state regulatory requirements.

Government Oversight of Bitcoin and Virtual Currency Exchanges. FinCEN—the U.S. federal agency charged with administering U.S. anti-money laundering ("AML") laws and regulations—issued guidance titled, FIN-2013-G001: *Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies* (Mar. 18, 2013), categorizing convertible virtual currency *administrators and exchangers* as money services businesses. The FinCEN guidance defines an exchanger as "a person engaged as a business in the exchange of virtual currency for real currency, funds or other virtual currency" and an administrator as "a person engaged as a business in issuing (putting into circulation) a virtual currency and who has the authority to redeem (to withdraw from circulation) such virtual currency." Users of Bitcoin were not directly affected by the guidance. Since the issuance of the guidance, FinCEN has published several administrative rulings, providing additional information on whether certain conduct related to convertible virtual currency renders a person or entity a money transmitter under FinCEN regulations. (*FIN-2014-R001: Application of FinCEN's Regulations to Virtual Currency Mining Operations*; *FIN-2014-R002: Application of FinCEN's Regulations to Virtual Currency Software Development and Certain Investment Activity; FIN-2014-R007: Application of Money Services Business regulations to the rental of computer systems for mining virtual currency*; *FIN-2014-R011: Application of FinCEN's Regulations to a Virtual Currency Trading Platform*; and *FIN-2015-R001, Application of FinCEN's Regulations to Persons Issuing Physical or Digital Negotiable Certificates of Ownership of Precious Metals)*. On May 9, 2019, FinCEN issued guidance titled, FIN-2019-G001: *Application of FinCEN's Regulations to Certain Business Models Involving Convertible Virtual Currencies*, in which FinCEN affirmed its longstanding regulatory framework for virtual currencies. The guidance does not establish any new regulatory expectations; rather, it consolidates current FinCEN regulations, guidance and administrative rulings that relate to money transmission involving virtual currency, and applies the same interpretive criteria to other common business models involving convertible virtual currencies. On May 9, 2019, FinCEN also issued an advisory titled, FIN-2019-A003: *Advisory on Illicit Activity Involving Convertible Virtual Currency*, to assist financial institutions in identifying and reporting suspicious activity related to criminal exploitation of convertible virtual currencies for money laundering, sanctions evasion, and other illicit financing purposes.

The FinCEN guidance and administrative rulings have clear consequences for companies that handle or transact with convertible virtual currencies (such as Bitcoin) to a degree in which they are engaged in money transmission. Under FinCEN's regulations, a person or entity engaging in money transmission must register as a "money services business," develop an AML program and adhere to federal reporting and recordkeeping requirements.

In the United States, the essential elements of an AML program are set out in the Bank Secrecy Act implementing regulations (31 CFR Chapter X): (1) a system of internal controls;

(2) independent testing for compliance; (3) the designation of an individual to coordinate and monitor day-to-day compliance; and (4) training of appropriate personnel. An AML program should establish and implement risk-based policies and procedures designed to prevent facilitation of money laundering or the funding of terrorism, including the reporting of suspicious transactions with FinCEN. Failure of a money services business to register as a money services business, develop and adequately implement an AML program or adhere to federal reporting and recordkeeping requirements may result in severe civil and criminal penalties for the money services business and/or those individuals who operate it.

On the state level, companies that handle virtual currencies may also have to comply with the separate state licensing practices for money transmitters, and a growing number of states have sought specific legislation, adopted rules, or provided guidance on the regulation of virtual currencies.

For example, in June 2015, the New York Department of Financial Services issued the first U.S. regulatory framework for licensing participants in "virtual currency business activity." The regulations, known as "BitLicense," focus on consumer protection. The BitLicense regulates the conduct of persons or entities that are involved in virtual currency business activity in New York or with New York customers and prohibits any person or entity involved in such activity to conduct activities without a license. In February 2018, State Senator David Carlucci stated that a bill to reform the BitLicense regulation may be introduced "very soon." In addition, on February 7, 2018, the New York Department of Financial Services issued guidance instructing virtual currency business entities with a "BitLicense" or chartered as a limited purpose trust company under the New York Banking Law to report "any wrongdoing" to prevent fraud and similar wrongdoing, including market manipulation, in the virtual currency sector. Other states have taken a different approach to regulating activities involving virtual currency.

On April 3, 2014, the Texas Department of Banking issued Supervisory Memorandum 1037, Regulatory Treatment of Virtual Currencies under the Texas Money Services Act ("**TMSA**"). The memorandum states that cryptocurrencies do not fit the statutory definitions of either currency or money, and consequently do not by themselves trigger the licensing requirements of the TMSA. However, some common business activities relating to cryptocurrency that involve the receipt of government-issued currency may trigger the licensing requirements of the TMSA. In January 2019, and again in April 2019, the Texas Department of Banking revised Supervisory Memorandum 1037 to clarify that sovereign-backed stablecoins may be considered money under the TMSA and, therefore, activity involving them may trigger licensing requirements.

On September 25, 2020, California Governor Gavin Newsom signed bills into law that establishes Department of Financial Protection and Innovation ("DFPI") and a new Division of Consumer Financial Protection, which will have a research department that monitors emerging financial products such as cryptocurrencies. Other states are seeking legislation, adopting rules or providing guidance (or have already done so) regarding virtual currency business activity. The expectation is that this trend will continue as states seek to protect businesses and consumers.

Further, various foreign jurisdictions are considering or have considered how to manage the use and exchange of virtual currencies. Recent examples include:

- On September 7, 2017, Mario Draghi, the President of the European Central Bank, stated that "[n]o member state can introduce its own currency", and that only "currency of the Eurozone is the Euro" in response to a question regarding Estonia's talks of circulating an Estonian cryptocurrency.

- On February 28, 2018, the European Commission held a roundtable of "key authorities, industry representatives and experts" on cryptocurrency and proposed that "virtual currency exchanges and wallet providers should be subject to the Anti-Money Laundering Directive."

- In September 2017, seven Chinese government administrations, including the People's Bank of China ("**PBOC**"), China Banking Regulatory Commission, China Securities Regulatory Commission, and China Insurance Regulatory Commission, issued a joint statement that cryptocurrency offerings are unauthorized illegal fund raising activity, In addition, several large Chinese Bitcoin exchanges, including BTC China, ViaBTC, Yunbi, OKCoin and Huobi, were reportedly ordered to stop trading cryptocurrency by the end of September 2017. In April 2019, China's National Development Reform Commission listed cryptocurrency mining as an industry that the commission intends to eliminate.

- In December 2017, the South Korean Financial Services Commission took steps to regulate cryptocurrency trading, including prohibiting cryptocurrency exchanges from issuing new trading accounts and banning anonymous trading.

- On June 27, 2019, Koinex, one of India's largest cryptocurrency exchanges, shut down because of the regulatory burdens placed on the cryptocurrency exchange by the Indian government. India's banking regulation had the greatest impact on Koinex, as they made it unlawful for banks to provide financial services to entities that facilitate the trade of virtual currencies.

- On January 16, 2014, an official from the Canadian Finance Department clarified that Bitcoin is not considered to be legal tender. On March 28, 2014, the Canadian parliament passed a bill amending its money laundering and terrorist financing act, making it applicable to persons in Canada engaged in the business of dealing in virtual currencies as well as persons outside Canada that provide such services to customers in Canada.

- On April 1, 2017, the Japanese Financial Services Agency enacted a new law authorizing the use of digital currency as a method of payment. The law will put in place capital requirements for exchanges as well as cybersecurity and operational stipulations. In addition, those exchanges will also be required to conduct employee training programs and submit to annual audits.

Bitcoin Tax Implications. On March 25, 2014, the Service issued a notice regarding the U.S. federal tax implications of transactions in, or transactions that use, virtual currency (the "Notice"). According to the notice, virtual currency is treated as property, not currency, for U.S. federal tax purposes, and "[g]eneral tax principles applicable to property transactions apply to transactions using virtual currency." In part, the Notice provides that the character of gain or loss from the sale or exchange of virtual currency depends on whether the virtual currency is a capital asset in the hands of the taxpayer. Accordingly, in the U.S., certain transactions in virtual currency are taxable events and subject to information reporting to the Service to the same extent as any other payment made in property.

Additionally, the Service recently issued a revenue ruling regarding certain tax consequences of "hard forks" and "airdrops" of a cryptocurrency (the "Revenue Ruling"). The Revenue Ruling provides that a taxpayer does not have gross income as a result of a hard fork of a cryptocurrency the taxpayer owns if the taxpayer does not receive units of a new cryptocurrency. However, an airdrop of a new cryptocurrency following a hard fork generally results in ordinary income to the taxpayer if the taxpayer receives units of new cryptocurrency.

Although the Service has issued the Notice and Revenue Ruling, the U.S. Department of Treasury and the Service may publish future guidance that provides for adverse tax consequences to the Fund and investors in the Fund. Shareholders should be aware that tax laws and Regulations (as defined below) change on an ongoing basis, and that they may be changed with retroactive effect. Moreover, the interpretation and application of tax laws and regulations by certain tax authorities may not be clear, consistent or transparent. As a result, the U.S. Federal tax consequences of investing in the Fund are uncertain, and the net asset value of the Fund at the time any subscriptions, redemptions or exchanges of Shares occur may not accurately reflect the Fund's direct or indirect tax liabilities, including on any historical realized or unrealized gains (including those tax liabilities that are imposed with retroactive effect). In addition, the net asset value of the Fund at the time any subscriptions, redemptions or exchanges of Shares occur may reflect a direct or indirect accrual for tax liabilities, including estimates of such tax liabilities, that may not ultimately be paid. Accounting standards may also change, creating an obligation for the Fund to accrue for a tax liability that was not previously required to be accrued for or in situations where it is not expected that the Fund will directly or indirectly be ultimately subject to such tax liability.

Additionally, application of tax laws and regulations may result in increased, ongoing costs, or accounting related expenses, adversely affecting an investment in the Fund. Also, outside the U.S. the tax rules applicable to virtual currency and the underlying Bitcoin in the Fund are uncertain. Accordingly, the costs or tax consequences to an investor or the Fund could differ from the investor's expectations. (See "Tax Aspects".)

*Bitcoin Service Providers. S*everal companies and financial institutions provide services related to the buying, selling, payment processing and storing of virtual currency (*i.e.*, banks, accountants, exchanges, digital wallet providers, and payment processors). The Fund expects the number of service providers to increase as the Bitcoin network continues to grow. However, there is no assurance that the virtual currency market, or the service providers necessary to accommodate it, will continue to support Bitcoin or other types of virtual currency, continue in existence or grow. Further, there is no assurance that the availability of and access to virtual currency service providers will not be negatively affected by government regulation or supply and demand of virtual currency or Bitcoin. Accordingly, companies or financial institutions that currently support virtual currency may not do so in the future.

Bitcoin Investment Market. Private and professional investors and speculators invest and trade in Bitcoin. These market participants may range from exchange-traded-funds, private investment funds, brokers and day-traders. Certain activity involving Bitcoin may require approvals, licenses or registration, which may serve as a barrier to entry of investors, thereby limiting the market for Bitcoin. There is no assurance that the investment market for Bitcoin will continue to grow.

Anonymity and Illicit Use. Although Bitcoin transaction details are logged on the blockchain, a buyer or seller of Bitcoin may never know to whom the public key belongs or the true identity of the party with whom it is transacting. Public key addresses are randomized sequences of 27-34 alphanumeric characters that, standing alone, do not provide sufficient information to identify users.

Transacting with a counterparty making illicit use of Bitcoin could have adverse consequences. On October 2, 2013, the FBI seized the domain name for the infamous "Silk Road" website—an online black marketplace for illicit goods and services—and arrested its alleged founder, Ross William Ulbricht. The website operated through multiple systems of strict anonymity and secrecy, using Bitcoin as the exclusive means of payment for illicit goods and services. As part of the raid, the FBI also seized over 26,000 Bitcoin from accounts on Silk Road, which were worth approximately $3.6 million at the time. In November 2020, the U.S. Department of Justice seized more than $1 billion in Bitcoin from an account linked to the Silk Road website. On January 27, 2014, the CEO of BitInstant (the New York-based Bitcoin exchange service) was arrested on charges of money laundering and operating an unlicensed money transmitting business. On July 24, 2017, FinCEN assessed a $110 million civil money penalty against BTC-e a/k/a Canton Business Corporation ("BTC-e"), an internet-based and foreign located digital currency exchange founded in 2011, for failing to register as a Money Services Business and facilitating crimes like drug sales and ransomware attacks. FinCEN also assessed separate $12 million fine against BTC-e's owner, Alexander Vinnik.

Risks Relating to Development and Acceptance of Bitcoin. As a relatively new product and technology, Bitcoin is not yet widely adopted as a means of payment for goods and services. Banks and other established financial institutions may refuse to process funds for Bitcoin transactions, process wire transfers to or from Bitcoin exchanges, Bitcoin-related companies or service providers, or maintain accounts for persons or entities transacting in Bitcoin. Market capitalization for Bitcoin as a medium of exchange and payment method may always be low. Further, Bitcoin use as an international currency may be hindered by the fact that it may not be considered as a legitimate means of payment or legal tender in some jurisdictions. To date, speculators and investors seeking to profit from either short- or long-term holding of Bitcoin drive much of the demand for it, and competitive products may develop which compete for market share. Although Bitcoin, as the first decentralized, virtual cryptocurrency, currently enjoys the majority of the market share, several other virtual cryptocurrencies have since emerged, including Ethereum, Ripple, Litecoin, Tether and Binance Coin. Further, other virtual currencies or payment systems may be the subject of a U.S. or foreign patent application (*i.e.*, JP Morgan Chase Bank's patent application for "Alt-Coin" with the United States Patent & Trademark Office), successfully patented, or, alternatively, Bitcoin-Qt may be patented or owned or controlled by a public or private entity. The Fund could be adversely impacted if Bitcoin fails to retain its market share, use of Bitcoin contracts, or it fails to expand into retail and commercial markets. Either scenario may increase Bitcoin's volatility or decrease its value (price).

Risks Relating to Development and Acceptance of the Bitcoin Network. The growth and use of virtual currencies generally, and the Bitcoin network specifically, is subject to a high degree of uncertainty. Indeed, the future of the industry likely depends on several factors, including, but not limited to: (a) economic and regulatory conditions relating to both fiat currencies and virtual currencies; (b) government regulation of the use of and access to virtual currencies; (c) government regulation of virtual currency service providers, administrators or exchanges; (d) the domestic and global market demand for—and availability of—other forms of virtual currency or payment methods; and, (e) uniquely regarding Bitcoin, the security, integrity and adoption of the Bitcoin network source code protocol. Any slowing or stopping of the development or acceptance of Bitcoin or the Bitcoin network may adversely affect an investment in the Fund.

Risks Related to Virtual Currency Exchanges

*General***.** The virtual currency exchanges on which Bitcoin trade are relatively new and generally unregulated and may therefore be more exposed to theft, fraud and failure than established, regulated exchanges for other products. Virtual currency exchanges may be start-up businesses with no institutional backing, limited operating history and no publically available financial information. Exchanges generally require cash to be deposited in advance in order to purchase Bitcoin, and no assurance can be given that those deposit funds can be recovered. Additionally, upon sale of Bitcoin, cash proceeds may not be received from the exchange for several business days. The participation in exchanges requires users to take on credit risk by transferring Bitcoin from a personal account to a third-party's account. The Fund will take credit risk of an exchange every time it transacts.

Virtual currency exchanges may impose daily, weekly, monthly or customer-specific transaction or distribution limits or suspend withdrawals entirely, rendering the exchange of virtual currency for fiat currency difficult or impossible. Additionally, Bitcoin prices and valuations on virtual currency exchanges have been volatile and subject to influence by many factors including the levels of liquidity on exchanges and operational interruptions and disruptions. The prices and valuation of Bitcoin remains subject to any volatility experienced by virtual currency exchanges, and any such volatility can adversely affect an investment in the Fund.

Virtual currency exchanges are appealing targets for cybercrime, hackers and malware. It is possible that while engaging in transactions with various Bitcoin exchanges located throughout the world, any such exchange may cease operations due to theft, fraud, security breach, liquidity issues, or government investigation. In addition, banks may refuse to process wire transfers to or from exchanges. Over the past several years, many exchanges have, indeed, closed due to fraud, theft (*e.g.*, Mt. Gox voluntarily shutting down because it was unable to account for over 850,000 Bitcoin), government or regulatory involvement, failure or security breaches (*e.g.*, the voluntary temporary suspensions by Mt. Gox of cash withdrawals due to distributed denial of service attacks by malware and/or hackers), or banking issues (*e.g.*, the loss of Tradehill's banking privileges at Internet Archive Federal Credit Union). In 2018 alone, virtual currency exchanges based in Japan (Coincheck), Italy (Bitgrail), India (Coinsecure) and South Korea (Coinrail) are reported to have experienced major hacks, resulting in losses of approximately $650,000,000 in total. In addition, significant hacks have occurred in 2019, including the theft of approximately 7,000 Bitcoin (equivalent to more than $40,000,000) from Binance, a prominent global cryptocurrency exchange, and in 2020, including a hack on a Singapore based crypotcurrency exchange KuCoin resulting in a loss of more than $150,000,000.

Exchanges may even shut down or go offline voluntarily, without any recourse to investors. For example, on February 25, 2014, the Bitcoin website for one of the largest Bitcoin exchanges, Mt. Gox, was taken offline suddenly, without any notice or warning to investors or the public. It was reported that Mt. Gox voluntarily shut down because it was unable to account for over 850,000 Bitcoin (valued at approximately 450 million dollars at the time). According to news reports, hackers siphoned Bitcoin from Mt. Gox by changing the unique identification number of a Bitcoin transaction before it was confirmed on the Bitcoin network. Although 200,000 Bitcoin have since been recovered, the reasons for their disappearance remain unclear. Mt. Gox ultimately filed for bankruptcy in Japan, and bankruptcy protection in Japan and the United States. As a result, the price of Bitcoin decreased drastically, adversely affecting all Bitcoin holders. In many of these instances, the customers of such exchanges have not been compensated or made whole for the partial or complete loss of their account balances. Consequently, An exchange may be unable to replace missing Bitcoin or seek reimbursement for any theft of Bitcoin, adversely affecting investors and an investment in the Fund.

Any financial, security or operational difficulties experienced by such exchanges may result in an inability of the Fund to recover money or Bitcoin being held by the exchange, or to pay investors upon redemption. Further, the Fund may be unable to recover Bitcoin awaiting transmission into or out of the Fund, all of which could adversely affect an investment in the Fund. Additionally, to the extent that the Bitcoin exchanges representing a substantial portion of the volume in Bitcoin trading are involved in fraud or experience security failures or other operational issues, such Bitcoin exchanges' failures may result in loss or less favorable prices of Bitcoin, or may adversely affect the Fund, its operations and investments, or Shareholders.

Limited Exchanges on Which to Trade Bitcoin. The Fund may trade on a limited number of exchanges (and potentially only a single exchange) either because of actual or perceived counterparty or other risks related to a particular exchange. Trading on a single exchange may result in less favorable prices and decreased liquidity for the Fund and therefore could have an adverse effect on the Fund and its Shareholders.

Non-U.S. Operations. Bitcoin exchanges may operate outside of the United States. The Fund may have difficulty in successfully pursuing claims in the courts of such countries or enforcing in the courts of such countries a judgment obtained by the Fund in another country. In general, certain less developed countries lack fully developed legal systems and bodies of commercial law and practices normally found in countries with more developed market economies. These legal and regulatory risks may adversely affect the Fund and its operations and investments.

Risks of Buying or Selling Bitcoin. The Fund may transact with private buyers or sellers or virtual currency exchanges. The Fund will take on credit risk every time it purchases or sells Bitcoin, and its contractual rights with respect to such transactions may be limited. Although the Fund's transfers of Bitcoin or fiat currency will be made to or from a counterparty which the

Investment Manager believes is trustworthy, it is possible that, through computer or human error, or through theft or criminal action, the Fund's Bitcoin or cash could be transferred in incorrect amounts or to unauthorized third parties. To the extent that the Fund is unable to seek a corrective transaction with such third-party or is incapable of identifying the third-party which has received the Fund's Bitcoin or cash (through error or theft), the Fund will be unable to recover incorrectly transferred Bitcoin or fiat currency, and such losses will negatively impact the Fund.

Certain virtual currency exchanges may place limits on the Fund's transactions, or the Fund may be unable to find a willing buyer or seller of Bitcoin. To the extent the Fund experiences difficulty in buying or selling Bitcoin, investors may experience delays in subscriptions or payment of redemption proceeds, or there may be delays in liquidation of the Fund's Bitcoin—adversely affecting the net asset value of the Fund.

Actual proceeds from the sale of Bitcoin may not reflect trading prices or market quotations, and receiving proceeds may be time consuming and expensive.

Risks Relating to Government Oversight. The regulatory schemes—both foreign and domestic—possibly affecting Bitcoin or the Bitcoin network may not be fully developed as of the Fund's inception. It is possible that any jurisdiction may, in the near or distant future, adopt laws, regulations, policies or rules directly or indirectly affecting the Bitcoin network, generally, or restricting the right to acquire, own, hold, sell, convert, trade, or use Bitcoin, or to exchange Bitcoin for either fiat currency or other virtual currency. It is also possible that government authorities may claim ownership over Bitcoin-Qt or law enforcement agencies (of any or all jurisdictions, foreign or domestic) may take direct or indirect investigative or prosecutorial action related to, among other things, the use, ownership or transfer of virtual currencies or Bitcoin, resulting in a change to its value or to the development of the Bitcoin network (*e.g.,* the closure and seizure of Silk Road and the closure and seizure of www.libertyreserve.com—the domain name for Liberty Reserve, an online, virtual currency payment processor and money transfer system that the U.S. government alleges acted as a financial hub of the cyber-crime world).

Federal Regulatory Authorities.

CFTC. The Commodity Futures Trading Commission ("CFTC") has not to date made a formal statement asserting its regulatory authority over Bitcoin or over any participants in the Bitcoin network. In addition, the CFTC has not to date promulgated any regulations specifically addressing Bitcoin or the activities of participants in the Bitcoin network. However, as the primary regulator of derivatives (*i.e.*, futures, options and swaps), the CFTC has jurisdiction over all such digital currency-linked derivatives, including the platforms that list them and the clearinghouses that clear them.

While the CFTC regulatory authority over cryptocurrency generally only extends to cryptocurrency derivatives, the CFTC has indicated that it does have a limited level of oversight over direct trading of cryptocurrencies; on September 21, 2017, the CFTC filed for injunctive relief against Gelfman Blueprint Inc, and its CEO, Nicholas Gelfman concerning an alleged Ponzi scheme. The CFTC asserted jurisdiction on the basis of Mr. Gelfman engaging in some Bitcoin trading, thereby engaging in manipulative trading in commodities. In August 2018, CabbageTech Corp was found guilty of fraudulent behavior in another case brought by the CFTC for " a deceptive and fraudulent virtual currency scheme." The CFTC has historically asserted jurisdiction over spot market commodities trading, where manipulative trading in the spot market can affect its derivatives market. The Gelfman case is unique in that the CFTC asserted jurisdiction over the spot market when there was little to no derivatives trading in the United States. *See CFTC v. Gelfman Blueprint, No. 17-7181 (S.D.N.Y. Sept. 21, 2017).* Similarly, the CabbageTech case did not indicate that there was any derivatives trading conducted, yet the court rejected the defendant's claim that the CFTC had no jurisdiction in the matter. *See CFTC vs. Patrick K. McDonnell, and Cabbagetech, Corp. d/b/a Coin Drop Markets, (No. 18-CV-0361) (E.D.N.Y. Aug. 24, 2018). See also Commodity Futures Trading Comm'n v. My Big Coin Pay, Inc.*, 334 F. Supp. 3d 492, 496–97 (D. Mass. 2018) (finding that defendants' virtual currency, "My Big Coin," was a commodity subject to CFTC anti-fraud and anti-manipulation authority, because contracts for future delivery of virtual currencies were already "dealt in"—even if futures contracts for My Big Coin, specifically, were not).

To the extent the Fund's activities are viewed as holding or offering Bitcoin derivatives (including futures, options and swaps), the Fund, the Investment Manager, or one or more companies in which it invests, may be required to register and comply with additional regulation under the Commodity Exchange Act, such as the Investment Manager registering as a commodity pool operator (where holding Bitcoin derivatives) or the Fund, or one of the companies in which it invests, registering as a swap execution facility or swap dealer (when offering certain Bitcoin derivatives) or by being subject to the CFTC requirements with respect to such instruments, such as reporting, recordkeeping, mandatory clearing or minimum margin requirements. Such registration and associated compliance costs could adversely affect an investment in the Fund.

SEC. The SEC has not formally asserted regulatory authority over Bitcoin or over any participants in the Bitcoin network. In addition, the SEC Chairman Clayton, in 2018, stated that cryptocurrencies, such as Bitcoin, "are replacements for sovereign currencies" and that such type of currency "is not a security".

With respect to other cryptocurrencies, on April 3, 2019, the SEC published a framework aimed at assisting in determining whether a cryptocurrency is a security (the "Framework"). Alongside the Framework, the SEC also published a no-action letter for TurnKey Jet, Inc. (the "TurnKey Letter"), which marks the first ever no-action letter regarding cryptocurrencies. Per the Framework and the TurnKey Letter, cryptocurrencies cannot be used to raise capital without implicating U.S. securities laws.

Prior to the Framework, the SEC had addressed the regulatory status of cryptocurrencies in various contexts. For example, on November 16, 2018, the SEC settled charges against CarrierEQ Inc. ("Airfox") and Paragon Coin Inc. ("Paragon"), two companies that sold digital tokens in ICOs in 2017. Airfox, a Boston-based startup, raised approximately $15 million worth of digital tokens ("AirTokens"), which were issued on a blockchain or distributed ledger to finance its development of a token-denominated "ecosystem" starting with a mobile application that would allow users in emerging markets to earn tokens and exchange them for data by interacting with advertisements. Paragon, an online entity, raised approximately $12 million worth of digital tokens ("PRG tokens") to be issued on a blockchain, or a distributed ledger to develop and implement its business plan to add blockchain technology to the cannabis industry and work toward legalization of cannabis. The SEC determined that both AirTokens and PRG tokens were "securities" and that, in turn, Airfox and Paragon violated Sections 5(a) and 5(c) of the Securities Act by offering and selling those securities without having a registration statement filed or in effect with the SEC or qualifying for exemption from registration with the SEC. The orders imposed $250,000 penalties against each company and both companies agreed to return funds to harmed investors, register the tokens as securities, file periodic reports with the SEC, and pay penalties. Airfox and Paragon consented to the orders without admitting or denying the findings.

To the extent that Bitcoin could in the future unexpectedly be deemed to fall within the definition of a security for purposes of U.S. laws and regulations (including by the SEC), the Fund may be required to comply with certain relevant U.S. law and regulations. Such associated compliance costs could adversely affect an investment in the Fund.

FinCEN. To the extent that the Fund engages in money services business activity, including money transmission, as defined by FinCEN, the Fund may be deemed to fall within the Bank Secrecy Act's definition of a financial institution, and subject to the Bank Secrecy Act, 31 U.S.C. §§ 5311-5314; 5316-5330, and its implementing regulations, and as such required to register as a money services business with FinCEN. The Fund would also be required to develop an AML program and adhere to U.S. federal reporting and recordkeeping requirements. To the extent the Fund is operating as an unregistered money services business, it may be subject to civil money penalties under 31 U.S.C. § 5321, and/or criminal liability under 31 U.S.C. § 5322 and 18 U.S.C. § 1960, if applicable. Such additional regulatory obligations may cause the Fund to incur extraordinary expenses and ongoing expenses, possibly affecting an investment in the Fund in a material and adverse manner. To the extent the Fund limits or reduces the scope of certain activities, investors' rights or investment initiatives, in order to limit the applicability of government regulation and supervision, investments in the Fund may be adversely affected.

State Regulatory Authorities. To the extent that the activities of the Fund cause it to be deemed a "money transmitter" under State statutes or regulations, it may incur significant fees in becoming licensed in each State in which it does business, and may also be required to adhere to State statutes or regulations. To the extent that a state requires an additional license or registration for activities involving digital currencies that require the Fund to obtain a license or register with the state for its activities involving digital currency, it may incur significant fees in becoming licensed/registered in those States, and may also be required to adhere to the State's statutes or regulations. States may impose fines or penalties with respect to any unlicensed activity. Accordingly, to the extent the Fund is operating without appropriate licenses, it may be subject to fines or penalties, and/or criminal liability under State laws or 18 U.S.C. § 1960, if applicable. Such additional regulatory obligations may cause the Fund to incur extraordinary expenses and ongoing expenses, possibly affecting an investment in the Fund in a material and adverse manner. To the extent the Fund limits or reduces the scope of certain Fund activities, investors' rights or investment initiatives, in order to limit the applicability of government regulation and supervision over the Fund, investment in the Fund may be adversely affected.

Foreign Jurisdictions. Various foreign jurisdictions may adopt policies, laws, regulations or directives that affect Bitcoin or the Bitcoin network, generally. Such additional foreign regulatory obligations may cause the Fund to incur extraordinary expenses and ongoing expenses, possibly affecting an investment in the Fund in a material and adverse manner.

To the extent Bitcoin is not recognized as legal currency, is determined to be a security, commodity interest or other regulated asset, or a U.S. or foreign government or quasi-governmental agency exerts regulatory authority over Bitcoin use, exchange, trading and ownership, the net asset value of the Fund may be adversely affected. Any additional regulatory obligations may cause the Fund to incur extraordinary, non-recurring expenses, and/or ongoing compliance expense, possibly affecting an investment in the Fund in an adverse manner. If the Fund determines not to comply with such regulatory requirements, the Fund may be liquidated at a time that is disadvantageous to an investor in the Fund. To the extent the Fund limits or reduces the scope of certain activities, investors' rights or investment initiatives, in order to limit the applicability of government regulation and supervision, investment in the Fund may be adversely affected.

Risks Relating to Bitcoin Price Volatility. A principal risk in trading Bitcoin is the rapid fluctuation of its market price. High price volatility undermines Bitcoin's role as a medium of exchange as retailers are much less likely to accept it as a form of payment. The value of the Shares relates directly to the value of the Bitcoin held in the Fund and fluctuations in the price of Bitcoin could adversely affect the net asset value of the Shares. There is no guarantee that the Fund will be able to achieve a better than average market price for Bitcoin or will purchase Bitcoin at the most favorable price available. The price of Bitcoin achieved by the Fund may be affected generally by a wide variety of complex and difficult to predict factors such as Bitcoin supply and demand; rewards and transaction fees for the recording of transactions on the blockchain; availability and access to virtual currency service providers (such as payment processors), exchanges, miners or other Bitcoin users and market participants; perceived or actual Bitcoin network or Bitcoin security vulnerability; inflation levels; fiscal policy; interest rates; and political, natural and economic events.

To the extent the public demand for Bitcoin were to decrease, or the Fund was unable to find a willing buyer, the price of Bitcoin could fluctuate rapidly and the Fund may be unable to sell the Bitcoin in its possession or custody. Shareholders with outstanding redemption requests will remain subject to the risk of price fluctuations of Bitcoin until they are fully redeemed from the Fund. Further, if the supply of Bitcoin available to the public were to increase or decrease suddenly due to, for example, a change in the Bitcoin source code, the dissolution of a virtual currency exchange, or seizure of Bitcoin by government authorities, the price of Bitcoin could fluctuate rapidly. Such changes in demand and supply of Bitcoin could adversely affect an investment in the Fund. In addition, governments may intervene, directly and by regulation, in the Bitcoin market, with the specific effect, or intention, of influencing Bitcoin prices and valuation (*e.g.,* releasing previously seized Bitcoin). Similarly, any government action or regulation may indirectly affect the Bitcoin market or Bitcoin network, influencing Bitcoin use or prices.

Currently, there is relatively modest use of Bitcoin in the retail and commercial marketplace compared to its use by speculators, thus contributing to price volatility that could adversely affect an investment in the Fund. If future regulatory actions or policies limit the ability to own or exchange Bitcoin in the retail and commercial marketplace, or use them for payments, or own them generally, the price and demand for Bitcoin may decrease. Such decrease in demand may result in the termination and liquidation of the Fund at a time that may be disadvantageous to Shareholders, or may adversely affect the Fund's net asset value.

The Fund will compete with direct investments in Bitcoin and other potential financial vehicles backed or linked to Bitcoin. Any change in market and financial conditions, or other conditions beyond the Fund's control, may make investment and speculation in Bitcoin more attractive, which could limit the supply of Bitcoin and increase or decrease liquidity.

Risks Relating to Loss or Destruction of Bitcoin. Bitcoin are intended to be controllable only by the possessor of both the unique public and private keys relating to the local or online digital wallet in which the Bitcoin are held. To the extent private keys relating to the Fund's Bitcoin holdings are lost, destroyed or otherwise compromised, the Fund will be unable to access the related Bitcoin and such private keys are not capable of being restored by the Bitcoin network. Any loss of private keys relating to digital wallets used to store the Fund's Bitcoin could adversely affect an investment in the Fund. Further, Bitcoin is transferred digitally, through electronic media not controlled or regulated by any entity. To the extent a Bitcoin transfers erroneously to the wrong destination, the Fund may be unable to recover the Bitcoin or its value. Such loss could adversely affect an investment in the Fund.

Risks Relating to Irrevocable Bitcoin Transactions. Just as the blockchain creates a permanent, public record of Bitcoin transactions, it also creates an irrevocable one. Transactions that have been verified, and thus recorded as a block on the blockchain, generally cannot be undone. Even if the transaction turns out to have been in error, or due to theft of a user's Bitcoin, the transaction is not reversible. The Fund may be unable to replace missing Bitcoin or seek reimbursement for any erroneous transfer or theft of Bitcoin. To the extent that the Fund is unable to seek redress for such action, error or theft, such loss could adversely affect an investment in the Fund. Under the Investment Manager's trade errors policy, in the absence of bad faith, Gross Negligence, willful misconduct or Fraud on the Investment Manager's part, the Fund (and not the Investment Manager) will benefit from any gains resulting from trade errors and will be responsible for any losses (including additional trading costs) resulting from trade errors and similar human errors.

Security of Cryptocurrency Networks. Techniques to secure the blockchains of cryptocurrency networks are recent inventions and may fail. For example, the incentives that keep a blockchain decentralized may prove insufficient, thus impacting the value or security of an investment held by the Fund. Exploitations in various blockchains may occur which result in losses for the Fund.

Risks Relating to Third-Party Wallet Providers. The Fund intends to use third-party wallet providers to hold the Fund's Bitcoin. The Fund may have a high concentration of its Bitcoin in one location or with one third-party wallet provider, which may be prone to losses arising out of hacking, loss of passwords, compromised access credentials, malware, or cyber-attacks. The Fund is not required to maintain a minimum number of wallet providers to hold the Fund's Bitcoin. The Fund may not conduct detailed information technology diligence on such third-party wallet providers and, as a result, may not be aware of all security vulnerabilities and risks. Certain third-party wallet providers may not indemnify the Fund against any losses of Bitcoin. Bitcoin held by third-parties could be transferred into "cold storage" or "deep storage," in which case there could be a delay in retrieving such Bitcoin. The Fund may also incur costs related to third-party storage. Any security breach, incurred cost or loss of Bitcoin associated with the use of a third-party wallet provider, may adversely affect an investment in the Fund.

Risks Relating to Bitcoin Security. The Fund intends to use third-party wallet providers to secure the Fund's Bitcoin. The Fund may, however, employ other systems to safeguard Bitcoin holdings, such as "cold storage" or "deep storage," which may increase the time required to access certain Bitcoin, and may, therefore, delay liquidation of the Fund's Bitcoin or payment of redemption proceeds, which could have a material adverse effect on the net asset value of the Fund. The systems in place to secure the Bitcoin may not prevent the improper access to, or damage or theft of the Fund's Bitcoin. Further, a security breach could harm the Fund's reputation or result in the loss of some or all of the Fund's Bitcoin, which represents the Fund's only asset. Any such security breach or leak of non-public information relating to the security of Bitcoin may adversely affect an investment in the Fund.

Risks Relating to Bitcoin Hackers. Hackers or malicious actors may launch attacks to steal, compromise, or secure Bitcoin, such as by attacking the Bitcoin network source code, exchange servers, third-party platforms, cold and hot storage locations or software, or Bitcoin transaction history, or by other means. For example, in February 2014, Mt. Gox suspended withdrawals because it discovered hackers were able to obtain control over the exchange's Bitcoin by changing the unique identification number of a Bitcoin transaction before it was confirmed by the Bitcoin network. Further, Flexcoin, a so-called Bitcoin bank, was hacked in March 2014 when attackers exploited a flaw in the code governing transfers between users by flooding the system with requests before the account balances could update—resulting in the theft of 896 Bitcoin. The Fund may be in control and possession of one of the largest holdings of Bitcoin. As the Fund increases in size, it may become a more appealing target of hackers, malware, cyber-attacks or other security threats. As a result, the Fund will undertake efforts to secure and safeguard the Bitcoin in its custody from theft, loss, damage, destruction, malware, hackers or cyber-attacks, which may add significant expenses to the operation of the Fund. There can be no assurance that such securities measures will be effective. The Fund may be unable to replace missing Bitcoin or seek reimbursement for any theft of Bitcoin, adversely affecting an investment in the Fund.

Risks Relating to Lack of Transparency. Given the type and extent of the security measures necessary to adequately secure Bitcoin, Shareholders will not fully know how the Fund stores or secures its Bitcoin or the Fund's complete holding of Bitcoin at any time.

Risks Relating to Reliance on Virtual Currency Service Providers. Due to audit and operational needs, there will be individuals who have information regarding the Fund's security measures. Any of those individuals may purposely or inadvertently leak such information. Further, several companies and financial institutions (including banks) provide support to the Fund related to the buying, selling, and storing of virtual currency. To the extent service providers no longer support the Fund or cannot be replaced, an investment in the Fund may be adversely affected.

Risks Relating to the Bitcoin Network Integrity and Security. The source code used to form the Bitcoin is attributed to "Satoshi Nakamoto" a pseudonym to a presently unidentified individual or group of individuals who may be acting alone or in concert with a government, government organization or group with malevolent tendencies. As such, only the portions of the source code that have been made public have been analyzed with regards to operation, ability to generate Bitcoin, and to conduct transactions in the previously described manner. There may exist an unseen portion of the original code wherein a pre-existing sub-routine and/or virus has been placed which will activate at a future time (determined by the original code writer(s)) causing disruptions to the blockchain and/or resulting in substantial losses, theft of Bitcoin, unauthorized transactions and the issuance of duplicate Bitcoin.

Further, since the identity of the original code writer(s) is not known, one cannot discount the possibility of the same unknown individual(s) inserting and/or activating a sub-routine or artifact allowing said person(s) to manipulate a portion of the Bitcoin programming and/or blockchain itself to the benefit of this individual(s) (*i.e.*, by programming a portion of each Bitcoin to transfer to such individual's Bitcoin wallet).

While the Investment Manager undertakes every effort to ensure the highest levels of data protection and information assurance internally (using industry-leading best practices for data storage and transmission, the strongest cryptography known and available to the private sector, and stringent internal controls on data and communications), at some points during the act of transferring a Bitcoin into or out of the Fund's platform (during Download or Upload) the Fund's platform requires interfacing with outside entities whose methods, practices and standards may be outside of the Fund's control or who may be under the influence of bad actors. Events may occur where corrupted Bitcoin, viruses and/or attachments are introduced into the Fund's platform, which could compromise the Fund's operation or result in loss of Bitcoin, adversely affecting an investment in the Fund.

There exists the possibility that while acquiring or disposing of Bitcoin, the Fund unknowingly engages in transactions with bad actors who are under the scrutiny of government investigative agencies. As such, the Fund's systems or a portion thereof may be taken off-line pursuant to legal process such as the service of a search and/or seizure warrant. Such action could result in the loss of Bitcoin previously under the Fund's control.

The development team and administrators of the Bitcoin network's source code could propose amendments to the network's protocols and software that, if accepted and authorized, or not accepted, by the Bitcoin network community, could adversely affect the supply, security, value, or market share of Bitcoin and thus an investment in the Fund. Further the Fund may be adversely affected by a manipulation of the Bitcoin source code.

Malicious Actor or Botnet. Malware is software used or programmed by malicious actors to disrupt computer operation, gather sensitive information or gain access to private computer systems. "Botnet" refers generally to a group of computers that use malware to compromise computers whose security defenses have been breached. To the extent that a malicious actor, cyber-criminal, computer virus, hacker, or botnet (*e.g.,* ZeroAccess) obtains a majority of the processing power on the Bitcoin network; alters the source code and blockchain on which all Bitcoin transactions rely; or prevents the use, transfer, ownership, or integrity of Bitcoin, an investment in the Fund could be adversely affected.

Forking. If Bitcoin miners solve a block at approximately the same time, it causes a "fork" in the blockchain. The Bitcoin network software and protocol try to resolve forks by automatically giving priority to the longest blockchain in the fork. If forks are unresolved there are effectively two Bitcoin networks operating at the same time, each with its own version of the transaction history. This creates an increased risk of receiving a double-spend transaction, and a general systemic risk to the integrity and security of the Bitcoin network.

To the extent that a significant majority of users and miners on the Bitcoin network install software that changes the Bitcoin network or properties of Bitcoin, including the irreversibility of transactions and limitations on the mining of new Bitcoin, the Bitcoin network would be subject to new protocols and software that may result in a "fork" of the Bitcoin network, adversely affecting an investment in the Fund. Similarly, if less than a significant majority of users and miners on the Bitcoin network install such software, the Bitcoin network could "fork," which may adversely affect an investment in the Fund. To the extent that any temporary or permanent forks exist in the blockchain, an investment in the Fund may be adversely affected.

On August 1, 2017 the Bitcoin blockchain experienced a hard "fork", resulting in the creation of Bitcoin Cash (BCH), a version of Bitcoin with its own set of rules, updated technology and faster transaction speed. As Bitcoin Cash emerged from the same ledger as Bitcoin, Bitcoin holders received the same amount of Bitcoin Cash tokens after the split and, as a result, now hold both Bitcoin, which will continue to be recorded on the original Bitcoin blockchain, and Bitcoin Cash, which will be recorded on the new "forked" blockchain. The hard "fork" was the result of a disagreement regarding the optimal size of the blocks that make up the Bitcoin network (some users, merchants, businesses, investors and miners desired to increase the block size, so as to allow for greater transaction confirmation speed, while Bitcoin's core developers desired to maintain the existing block size, so as to protect Bitcoin from potential hacks and more strongly preserve Bitcoin's decentralized nature (as some miners would not install the new, updated, software)). Furthermore, the Bitcoin blockchain experienced hard "forks" on October 24, 2017, resulting in Bitcoin Gold (BTG), and on November 15, 2018, resulting in Bitcoin SV (BSV).

The Bitcoin blockchain may continue to experience additional hard "forks", which may or may not have upgraded consensus rules that allow it to grow and scale. There is no guarantee that merchants, wallets or exchanges will support, or that a market will develop for, Bitcoin Cash, Bitcoin Gold, Bitcoin SV and/or future Bitcoin tokens, which may also compete with Bitcoin (negatively affecting its value). In addition, hard "forks" may carry further risks, including, without limitation, (i) that Bitcoin networks heavily decline in value or that the combined value of the competing versions of Bitcoin is less than the value of a single Bitcoin network (particularly, if the "fork" is interpreted as a general failure to reach a consensus regarding the Bitcoin network), (ii) that developers, service providers and users choose one version of Bitcoin over another and (iii) that the division of mining power makes each Bitcoin blockchain slower and/or less secure.

Mining Incentives. If rewards and transaction fees are not properly matched to the efforts of miners, miners may not have an adequate incentive to continue mining. Miners ceasing operations could reduce the collective processing power on the Bitcoin network, adversely affect the validation process for transactions, and, generally, make the network more vulnerable. Further, if a single miner or a mining pool gains a majority share in the Bitcoin network's computing power, the integrity of the blockchain may be affected. A miner or mining pool could reverse Bitcoin transactions, make double-spend transactions, prevent confirmations or prevent other miners from mining valid blocks. Each of these scenarios could reduce confidence in the validation process or processing power of the network, and adversely affect an investment in the Fund.

As the number of Bitcoin awarded for solving a block in the blockchain decreases, the incentive for miners to continue to contribute processing power to the Bitcoin network may transition from a set reward to transaction fees. Either the requirement from miners of higher transaction fees in exchange for recording transactions in the blockchain or a software upgrade that automatically charges fees for all transactions may decrease demand for Bitcoin and prevent the expansion of the Bitcoin network to retail merchants and commercial businesses, resulting in a reduction in the net asset value of the Fund.

To the extent that any miners cease to record transactions in solved blocks, transactions that do not include the payment of a transaction fee will not be recorded on the blockchain until a block is solved by a miner who does not require the payment of transaction fees. Any such delays in the recording of transactions could result in a loss of confidence in the Bitcoin network, which could adversely impact an investment in the Shares.

Changes to Underlying Protocol. In general, the underlying software protocols which govern the operation of Bitcoin network are open source and anyone can use, copy, modify, and distribute them. The Shareholder acknowledges and agrees (i) that the Fund makes no guarantee of the functionality, security, or availability of underlying protocols; (ii) that some underlying protocols are subject to consensus-based proof of stake validation methods which may allow, by virtue of their governance systems, changes to the associated blockchain or digital ledger ("**Governance Modifiable Blockchains**"), and that any transaction made by the Fund validated on such Governance Modifiable Blockchains may be affected accordingly; and (iii) that the underlying protocols are subject to sudden changes in operating rules (a/k/a "**forks**"), and that such forks may materially affect the value, function, and/or even the name of Bitcoin stores in Shareholder's account. In the event of a fork, the Investment Manager may temporarily suspend the Fund's operations (with or without notice to Shareholder) and the Investment Manager may, in its sole discretion, decide whether or not to support (or cease supporting) either branch of the forked protocol entirely. The Fund assumes absolutely no liability, obligation or responsibility whatsoever in respect to the operation of underlying software protocols, transactions affected by Governance Modifiable Blockchains, or an unsupported branch of a forked protocol and, accordingly, a Shareholder acknowledges and assumes the risk of the same.

Risks Relating to Legal Claims. To the extent that the creation, use or circulation of Bitcoin, or the Bitcoin network, generally, violates any foreign or domestic statute or regulation (such as the Stamp Payments Act of 1862 or US. federal counterfeiting statutes), or government, quasi-government, or private-individuals assert intellectual property claims against the Bitcoin network source code or related mathematical algorithms, the Fund could be adversely affected. The Fund cannot verify the legitimacy of claims to ownership of Bitcoin invested in the Fund. To the extent that any individual, institution, government or other authority asserts a claim of ownership or wrongful possession over the Bitcoin in the custody of the Fund, the Fund could be adversely affected. Regardless of the merit of such legal action, confidence in Bitcoin and the Bitcoin network may adversely affect an investment in the Fund.

Risks of "Buy and Hold" Strategy. The Investment Manager intends to cause the Fund to purchase Bitcoin to satisfy subscriptions and to sell Bitcoin in exchange for fiat currency only to satisfy redemptions. Absent redemption requests, the Investment Manager will not sell Bitcoin on behalf of the Fund even if the Investment Manager believes that the trading price of

Bitcoin will decline significantly. Although the Investment Manager has the right to manage the Fund with the objective of realizing assets in an orderly manner and distributing the proceeds to Shareholders in the event that the investment program of the Fund is no longer viable, the Investment Manager will not wind down the Fund based solely on a drop in the trading price of Bitcoin, regardless of how significant. The Investment Manager's long-term, long only "buy and hold" strategy, the failure of a Shareholder to submit a redemption, or the inability of the Fund to satisfy redemption requests could result in significant losses and potentially the loss of all of the Fund's capital.

Risks of Uninsured Losses. Though the Fund may seek to insure its Bitcoin holdings, it may not be possible, either because of a lack of available policies or because of prohibitive cost, for the Fund to obtain insurance of any type that would cover losses associated with Bitcoin. If an uninsured loss occurs or a loss exceeds policy limits, the Fund could lose a portion or all of its assets. The Fund's Bitcoin are not covered by the Federal Deposit Insurance Corporation or the Securities Investor Protection Corporation.

Bitcoin Lending. The Fund may lend Bitcoin on a collateralized and an uncollateralized basis from its portfolio to creditworthy securities firms, financial institutions and other third-party borrowers (and affiliates of the Fund and/or the Investment Manager). While such loan is outstanding, the Fund will receive interest on the investment of the collateral or a fee from the borrower. The risks in lending Bitcoin, as with other extensions of secured credit, if any, consist of possible delay in receiving additional collateral, if any, or in recovery of Bitcoin or possible loss of rights in the collateral, if any, should the borrower fail financially. Furthermore, during the time any Bitcoin is in the possession of such borrower, such Bitcoin may be kept in custody that provides a different level of security than that of the Fund's custodian. In addition, Bitcoin lending may be treated for U.S. federal income tax purposes as a sale of the lent Bitcoin, which would cause the Fund to recognize any built-in gain or loss in such Bitcoin.

Risks Relating to Market Conditions Generally

General Economic and Market Conditions

The success of any private investment fund's activities may be affected by general economic and market conditions, such as economic uncertainty, changes in laws (including laws relating to taxation of the Fund's investments), and national and international political circumstances (including wars, terrorist acts or security operations), although the success of the Fund's Bitcoin-focused investment strategy may be less correlated to changes in general economic and market conditions.

Governmental Interventions. Extreme volatility and illiquidity in markets has in the past led to extensive governmental interventions in equity, credit and currency markets, and it is possible that similar interventions may occur in the market(s) for cryptocurrency. Generally, such interventions are intended to reduce volatility and precipitous drops in value. In certain cases, governments have intervened on an "emergency" basis, suddenly and substantially eliminating market participants' ability to continue to implement certain strategies or manage the risk of their outstanding positions. In addition, these interventions have typically been unclear in scope and application, resulting in uncertainty. It is impossible to predict when these restrictions will be imposed, what the interim or permanent restrictions will be and/or the effect of such restrictions on the Fund's strategy.

Brexit. The UK formally withdrew from the European Union on January 31, 2020. The ongoing withdrawal process could cause an extended period of uncertainty and market volatility, not just in the UK but throughout the European Union, the EEA and globally. It is not possible to ascertain the precise impact these events may have on the Fund or the Investment Manager from an economic, financial or regulatory perspective but any such impact could have material consequences for the Fund.

No Diversification. The Investment Manager will concentrate the Fund's investments in Bitcoin. Losses incurred in the Fund's investments in Bitcoin would have a material adverse effect on the Fund's overall financial condition.

CUSTODY OF THE FUND'S BITCOIN

Bitcoin will be held and safeguarded in a manner determined by the Investment Manager to be in the best interest of the Fund. Specifics of the Investment Manager's integral security system of Bitcoin are proprietary information which is known by only a few key employees who control, manage and protect the Investment Manager's security protocol. The Fund will endeavor to keep in place procedures to reduce risk of loss or theft of Bitcoin. The Investment Manager is focused on maintaining a high level of security, and closely monitors the advances and best practices within the Bitcoin ecosystem regarding Bitcoin custody and security.

OTHER ACTIVITIES OF MANAGEMENT; POTENTIAL CONFLICTS OF INTEREST

The Investment Manager and its affiliates are subject, and the Fund is exposed, to a number of actual and potential conflicts of interest. Any such conflict of interest could have a material adverse effect on the Fund and the Shareholders' investments therein. However, the existence of an actual or potential conflict of interest does not mean that it will be acted upon to the detriment of the Fund. When a conflict of interest arises, the Investment Manager will endeavor to ensure that the conflict is resolved fairly and in an equitable manner that is consistent with its fiduciary duties to the Fund. The Investment Manager has in place policies and procedures that it believes are reasonably designed to identify and resolve actual and potential conflicts of interest. Unless the context clearly indicates otherwise, references in this section to conflicts of interest that may apply to the Investment Manager should be understood to apply to the Investment Manager and its affiliates.

Prospective Shareholders should understand that (i) the relationships among the Fund, the Other Accounts, the Investment Manager and its affiliates are complex and dynamic and (ii) as the Investment Manager's and the Fund's businesses change over time, the Investment Manager and its affiliates may be subject, and the Fund may be exposed, to new or additional conflicts of interest. There can be no assurance that this Memorandum addresses or anticipates every possible current or future conflict of interest that may arise or that is or may be detrimental to the Fund or the Shareholders. *Prospective Shareholders should consult with their own advisers* *regarding the possible implications on their investment in the Fund of the conflicts of interest described in this Memorandum.*

Other Activities of the Investment Manager and its Affiliates

Conflicts of interest may arise from the fact that the Investment Manager and its affiliates provide investment management services to clients other than the Fund, including, without limitation, investment funds, separately managed accounts, proprietary accounts and other investment vehicles (collectively, "Other Accounts", and together with the Fund, the "Accounts" and each, an "Account"). The Fund will not typically have an interest in any Other Accounts.

The Investment Manager and its affiliates also engage in a broad spectrum of activities, including direct investment activities (including trading in Bitcoin and other alternative currencies outside of the Fund) and investment advisory activities, and have extensive investment activities (including investments for their own account), on behalf of both persons or entities to which they provide investment advice on a principal basis, that are independent from, and may from time to time conflict or compete with, the Fund's investment activities, including by buying or selling Bitcoin at different times than the Fund, or when the Fund is doing the opposite. Additionally, the Investment Manager and its affiliates invest in or operate Bitcoin exchanges or other Bitcoin service providers and provide investment advisory services to Other Accounts that invest in alternative currencies that compete with Bitcoin.

Other Accounts may have investment objectives, programs, strategies and positions that are similar to or may conflict with those of the Fund, or may compete with or have interests adverse to the Fund. If Other Accounts invest in Bitcoin, this could affect the prices and availability of Bitcoin to the Fund. Other Accounts may buy and sell Bitcoin at different times than the Fund. Conflicts of interest may also arise when the Investment Manager makes decisions on behalf of the Fund with respect to matters where the interests of the Investment Manager or one or more Other Accounts differs from the interests of the Fund.

Liquidation of Assets of Other Accounts and Other Classes

The Investment Manager and its affiliates may provide investment management services to Other Accounts (including managed accounts and investment funds formed for a single investor or group of affiliated investors (each such fund, a "Fund of One")) that may have investment objectives, programs or strategies that are similar to those of the Fund, which could result in significant overlapping positions among the Fund and such Other Accounts. In addition, such Other Accounts may have different or additional terms than those of the Shares described in this Memorandum, including different fees, information rights and liquidity rights (including the right to wind down and terminate a managed account or Fund of One without cause). Additional information may affect an investor's decision to invest additional capital in, to remain invested in, to withdraw from or to terminate an Other Account. Any such withdrawals or terminations could cause any such Other Account to liquidate its positions ahead of the Fund, which may have a material adverse effect on the Fund and the Shareholders' investments therein. Similarly, to the extent that the Fund establishes Tranches of Shares with different liquidity rights, certain Shareholders may be able to act on information before any Shareholder that has less frequent liquidity rights.

Lack of Exclusivity

The Investment Manager, its affiliates and personnel will devote as much of their time to the activities of the Fund as they deem necessary and appropriate. The Investment Manager, its affiliates and personnel will not be restricted from forming Other Accounts, from entering into other investment advisory relationships or from engaging in other business activities, even if such activities may be in competition with the Fund and/or may involve substantial time and resources of the Investment Manager, its affiliates or personnel. These activities could be viewed as creating a conflict of interest in that the time and effort of the Investment Manager, its affiliates and personnel will not be devoted exclusively to the business of the Fund but will be allocated between the business of the Fund and the management of Other Accounts and businesses.

Investments by the Principal, Senior Management and Key Employees in the Fund and Other Accounts

Subject to applicable regulatory restrictions, the Principal, senior management and key employees of the Investment Manager may choose to personally invest, directly and/or indirectly, in the Fund. Such investors may be in possession of information relating to the Fund that is not available to other Shareholders and prospective Shareholders. The Principal, senior management and key employees are not required to keep any minimum investment in the Fund and may invest in Other Accounts. It is expected that, if such investments are made, the size and nature of these investments will change over time without notice to the Shareholders. Investments by the Principal, senior management and key employees in the Fund and/or Other Accounts could incentivize the Principal, senior management and key employees to increase or decrease the risk profile of the Fund.

Investments in Bitcoin by Investment Manager Personnel

Subject to certain exceptions, the Investment Manager may, for its own accounts, and its principals may, for their own accounts buy and sell Bitcoin other than through the Fund and/or the Related Investment Vehicles. Other employees of the Investment Manager and its affiliates are permitted to purchase Bitcoin outside the Fund and/or the Related Investment Vehicles.

The Investment Manager, its affiliates and its employees may give advice or take action for their own accounts that may differ from, conflict with or be adverse to advice given or action taken for the Fund.

Allocations of Trades and Investment Opportunities

It is the policy of the Investment Manager to allocate investment opportunities to the Fund and to any Other Accounts on a fair and equitable basis, to the extent practical and in accordance with the Fund's or Other Accounts' applicable investment strategies, over a period of time. Investment opportunities will generally be allocated among those Accounts for which participation in the respective opportunity is considered appropriate, taking into account, among other considerations: (i) whether the risk-return profile of the proposed investment is consistent with an Account's objectives; (ii) the potential for the proposed investment to create an imbalance in an Account's portfolio; (iii) the liquidity requirements of an Account; (iv) potentially adverse tax consequences; (v) regulatory restrictions that would or could limit an Account's ability to participate in a proposed investment; and (vi) the need to re-size risk in an Account's portfolio.

Order Aggregation and Average Pricing

If the Investment Manager purchases or sells Bitcoin for the Fund and any Other Accounts, the Investment Manager may, but is not obligated to, purchase or sell Bitcoin on behalf of such Accounts with an aggregated order, for the purpose of reducing transaction costs, to the extent permitted by applicable law. When an aggregated order is filled through multiple trades at different prices on the same day, each participating Account will receive the average price, with transaction costs generally allocated *pro rata* based on the size of each Account's participation in the order (or allocation in the event of a partial fill) as determined by the Investment Manager. In the event of a partial fill, allocations may be modified on a basis that the Investment Manager deems to be appropriate, including, for example, in order to avoid odd lots or *de minimis* allocations. When orders are not aggregated, trades generally will be processed in the order that they are placed with the broker or counterparty selected by the Investment Manager. As a result, certain Bitcoin trades for one Account (including an Account in which the Investment Manager and its personnel may have a direct or indirect interest) may receive more or less favorable prices or terms than another Account, and orders placed later may not be filled entirely or at all, based upon the prevailing market prices at the time of the order or trade. In addition, some opportunities for reduced transaction costs and economies of scale may not be achieved.

Cross Trades

The Investment Manager may determine that it would be in the best interests of the Fund and one or more Other Accounts to transfer Bitcoin from one Account to another (each such transfer, a "Cross Trade") for a variety of reasons, including, without limitation, tax purposes, liquidity purposes, to rebalance the portfolios of the Accounts, to satisfy redemption requests by transferring to an Account with subscription requests, or to reduce transaction costs that may arise in an open market transaction. If the Investment Manager decides to engage in a Cross Trade, the Investment Manager will determine that the trade is in the best interests of both of the Accounts involved and take steps to ensure that the transaction is consistent with the duty to obtain best execution for each of those Accounts. A cross transaction between two fund clients may occur as an "internal cross", where the Investment Manager instructs the custodian for the Accounts to book the transaction at the price determined in accordance with the Investment Manager's valuation policies. If the Investment Manager effects an internal cross, the Investment Manager will not receive any fee in connection with the completion of the transaction.

Principal Transactions

To the extent that Cross Trades may be viewed as principal transactions (as such term is used under the Advisers Act) due to the ownership interest in an Account by the Investment Manager or its personnel, the Investment Manager will comply with the requirements of Section 206(3) of the Advisers Act. In connection with principal transactions, Cross Trades, related-party transactions and other transactions and matters involving potential conflicts of interest, the Board of Directors is authorized to select one or more persons who are not affiliated with the Investment Manager to serve on an Advisory Committee, the purpose of which is to consider and, on behalf of the Shareholders and, if desired by the Board of Directors, the investors in any other feeder fund in the Fund, approve or disapprove, to the extent required by applicable law or deemed advisable by the Board of Directors, such transactions and conflicts of interest. The Advisory Committee may approve of such transactions prior to or contemporaneous with, or ratify such transactions subsequent to, their consummation. In no event will any such transaction be entered into unless it complies with applicable law. The member(s) of the Advisory Committee shall be exculpated and indemnified by the Fund for any Indemnified Losses, except for any Indemnified Losses that are Judicially Determined to be primarily attributable to the Fraud of such member of the Advisory Committee. Any decision of the Advisory Committee will be binding on all Shareholders.

Trade Errors

The Fund may on occasion experience errors with respect to trades made on its behalf. Trade errors may include, for example, (i) the placement of orders (either purchases or sales) in excess of the amount of Bitcoin the Fund intended to trade; (ii) the sale of Bitcoin when it should have been purchased; (iii) the purchase of Bitcoin when it should have been sold; (iv) the purchase or sale of Bitcoin contrary to regulatory restrictions or Fund investment guidelines or restrictions; (v) incorrect allocations of trades; and (vi) keystroke errors that occur when entering trades into an electronic trading system. Trade errors may result in losses or gains. The Investment Manager generally will endeavor to detect trade errors prior to settlement and correct and/or mitigate them in an expeditious manner. However, this may not be practicable with respect to Bitcoin. To the extent an error is caused by a counterparty, the Investment Manager will seek to recover any losses associated with such error from the counterparty. Pursuant to the exculpation and indemnification provided by the Fund to the Investment Manager and its affiliates and personnel, the Investment Manager and its affiliates and personnel will generally not be liable to the Fund for any act or omission, absent bad faith, Gross Negligence, willful misconduct or Fraud and the Fund will generally be required to indemnify such persons against any losses they may incur by reason of any act or omission related to the Fund, absent bad faith, Gross Negligence, willful misconduct or Fraud. As a result of these provisions, the Fund (and not the Investment Manager) will benefit from any gains resulting from trade errors and will be responsible for any losses (including additional trading costs) resulting from trade errors and similar human errors, absent bad faith, Gross Negligence, willful misconduct or Fraud. The Investment Manager will reimburse the Fund for losses for which the Investment Manager is responsible under the exculpation provisions. Given the potentially large volume of transactions executed by the Investment Manager on behalf of the Fund, investors should assume that trade errors (and similar errors) will occur and that, to the extent permitted by law and under the Fund Documents, the Fund will be responsible for any resulting losses, even if such losses result from the negligence (but not Gross Negligence) of the Investment Manager's personnel.

Side Letters

The Fund, and in certain cases the Investment Manager, will have the discretion to waive or modify the application of, or grant special or more favorable rights with respect to, any provision of this Memorandum or the Fund Documents to the extent permitted by applicable law. To effect such waivers or modifications or the grant of any special or more favorable rights, the Fund may create additional Tranches of Shares for certain Shareholders that provide for, among other things, (i) different or more favorable redemption rights, such as more frequent redemptions or shorter redemption notice periods, (ii) greater information than may be provided to other Shareholders, (iii) different fee or incentive compensation terms, (iv) more favorable transfer rights and (v) key-person notifications. Certain such waivers, modifications or grants of special or more favorable rights may also be effected by the Fund, and, in certain cases, the Investment Manager, through agreements ("Side Letters"). Although certain Shareholders may invest in the Fund with different material terms, the Fund and the Investment Manager generally will only offer such terms if they believe other Shareholders in the Fund will not be materially disadvantaged. The Fund may create additional Tranches of Shares, and the Fund, or in certain cases the Investment Manager, may enter into Side Letters with Shareholders without providing prior notice to, or receiving consent from, other Shareholders.

The Investment Manager Could Have Different Compensation Arrangements with Other Accounts

The Investment Manager could be subject to a conflict of interest because varying compensation arrangements among the Fund and Other Accounts could incentivize the Investment Manager to manage the Fund and such Other Accounts differently. These and other differences could make the Fund less profitable to the Investment Manager than certain Other Accounts.

Selection of Exchanges and Counterparties; Affiliated Bitcoin Service Providers

The Investment Manager may be subject to conflicts relating to its selection of Bitcoin intermediaries, exchanges and counterparties on behalf of the Fund. Portfolio transactions for the Fund will be allocated to intermediaries, exchanges and counterparties on the basis of numerous factors and not necessarily lowest pricing. Intermediaries, exchanges and counterparties may provide other services that are beneficial to the Investment Manager or Other Accounts, but not necessarily beneficial to the Fund.

In addition, the Investment Manager, its affiliates and/or Other Accounts may invest in or establish Bitcoin exchanges or other Bitcoin service providers, including businesses that focus on storage, security and custody of Bitcoin. The Investment Manager may cause the Fund to transact with such affiliated service providers. Such affiliated service providers will receive compensation when effecting Bitcoin transactions on behalf of the Fund.

Shareholders will have no right to request which Bitcoin service providers, intermediaries, exchanges and counterparties the Fund transacts with or invests in, and should not expect the Fund to accommodate any such requests.

Service Providers

The Administrator and other service providers may also provide services to other vehicles with similar investment programs and, accordingly, may have conflicts of interest. In addition, subject to applicable law, any of the service providers may deal, as principal or agent, with the Fund; *provided*, that such dealings are on normal commercial terms negotiated on an arm's-length basis. The Fund's service providers and their principals, employees or affiliates may trade in Bitcoin and/or other alternative currencies outside of the Fund, which may conflict or compete with the Fund, including by buying or selling Bitcoin when the Fund is doing the opposite.

Conflicts Relating to the Directors of the Fund

The directors of the Fund are not required to devote their full time and attention to the business of the Fund and may serve as directors of other investment vehicles. Accordingly, to the extent that the interests of the Fund and such other investment vehicles are inconsistent, such directors may have a conflict of interest.

Diverse Investor Base

The Shareholders may have conflicting investment, tax and other interests with respect to their investments in the Fund. As a consequence, conflicts of interest may arise in connection with decisions made by the Investment Manager that may be more beneficial for one Shareholder than for another Shareholder. In operating the Fund, the Investment Manager will consider the investment and tax objectives of the Fund as a whole, not the investment, tax or other objectives of any Shareholder individually. Consequently, the Investment Manager may make decisions from time to time that may be more beneficial to one type of Shareholder than another. For example, such decisions may (directly or indirectly) be more beneficial to Shareholders affiliated with the Investment Manager than to other Shareholders.

NET ASSET VALUE

The net asset value of a Tranche of Shares will be equal to the excess of the value of the assets over the value of the liabilities attributable to such Tranche as of any date of determination. The net asset value per Share of a Tranche is determined by dividing the net asset value of each Tranche by the number of Shares thereof. The net asset value of the Fund or a Tranche of Shares will generally be determined daily and at such other times as determined by the Board of Directors.

The Investment Manager will establish policies from time to time to value the investments held by the Fund. The Investment Manager has, at present, established the policies described below. The Board has ultimate responsibility for oversight of the valuation process and reviews and approves, at least annually, the Fund's valuation policies and procedures applied by the Investment Manager.

For purposes of subscriptions, redemptions, Management Fees and Realization Fees, the net asset value of the Fund's Bitcoin will be calculated incorporating TWAP. To determine the TWAP for each day, the Investment Manager will calculate the average price of Bitcoin in U.S. dollars on the Exchanges over the relevant Business Day.

Notwithstanding the foregoing, the net asset value reported in the Fund's annual audited financial statements will be valued in accordance with GAAP, and thus, will be calculated based on the price of Bitcoin set by the Exchange representing the principal market, in the Investment Manager's sole discretion, on the last day of each Fiscal Year. As a result, the net asset value reported in the Fund's audited financial statements may differ from the net asset value used for purposes of calculating subscription or redemption valuations, Management Fees and Realization Fees and reflected in each Shareholder's net asset value statements.

There is no guarantee that the value determined with respect to Bitcoin by the Investment Manager will represent the value that will be realized by the Fund on the eventual disposition of such Bitcoin or that would, in fact, be realized upon an immediate disposition of Bitcoin. (See "Selection of Exchanges and Counterparties; Affiliated Bitcoin Service Providers.")

All determinations made by the Investment Manager with respect to net asset value, TWAP and Median Trading Volume will be conclusive and binding. Shareholders will be provided with notice of any material modification to the valuation procedures set forth above and as further described herein.

THE ADMINISTRATOR

The Fund has entered into an administration agreement (the "Administration Agreement"), with SEI Global Services, Inc. (the "Administrator") pursuant to which the Administrator performs certain administrative and accounting services for the Fund, subject to the oversight and control of the Investment Manager.

Pursuant to the Administration Agreement, the Administrator is responsible, under the overall supervision of the Investment Manager, for certain matters pertaining to the day-to-day administration of the Fund including, but not limited to: (a) maintaining books and records related to Fund cash reconciliations, and portfolio transactions; (b) preparation of financial statements and other reports for the Fund; (c) calculating the net asset value of the Fund (in accordance with the Investment Manager's valuation policies and procedures); (d) preparing certain reports to investors; (e) calculating fees payable or allocable to the Investment Manager (as applicable); (f) reviewing Subscription Documents and withdrawal requests and performing various other transfer agency and investor services; and (g) performing certain other administrative and clerical services in connection with the administration of the Fund pursuant to the terms of the Administration Agreement. For purposes of determining net asset value, the Administrator will follow the valuation policies and procedures adopted by the Fund and the Investment Manager.

The fees payable to the Administrator will be based on the schedule of fees charged by the Administrator, calculated by reference to the net asset value of the Fund and as detailed in the Administration Agreement. The Fund may elect to terminate the Administration Agreement (in accordance with the terms thereof) and enter into a new agreement with a new administrator on behalf of the Fund, in its discretion and on such terms as it deems advisable, without prior notice to, or approval of, the Investors.

The Administration Agreement provides that the Administrator may delegate some or all of its administrative functions on behalf of the Fund to one or more third parties, and also provides for certain limitations of the Administrator's liability and indemnification of the Administrator by the Fund.

The Administrator in no way acts or will act as guarantor or offeror of interests in the Fund or any underlying investment, nor will it be responsible for the actions of the Fund's sales agents, its brokers, its custodians, any other brokers or the Investment Manager. The Administrator will not be responsible for any trading decisions of the Investment Manager or the Fund. The Administrator will not be responsible in any way for the Fund's selection or ongoing monitoring of its brokers, custodians or other counterparties. The decision to select any counterparties on behalf of the Fund will be made solely by the Investment Manager.

THE ADMINISTRATOR WILL NOT PROVIDE ANY INVESTMENT ADVISORY OR INVESTMENT MANAGEMENT SERVICES TO THE FUND AND, THEREFORE, WILL NOT BE IN ANY WAY RESPONSIBLE FOR THE FUND'S PERFORMANCE. THE ADMINISTRATOR WILL NOT BE RESPONSIBLE FOR MONITORING ANY INVESTMENT RESTRICTIONS OR COMPLIANCE WITH ANY INVESTMENT RESTRICTIONS APPLICABLE TO THE FUND AND THEREFORE WILL NOT BE LIABLE FOR ANY BREACH THEREOF.

TAX ASPECTS

The following is a summary of certain aspects of the income taxation of the Fund and its Shareholders which should be considered by a prospective Shareholder. The Fund has not sought a ruling from the Internal Revenue Service (the "Service") or any other Federal, state or local agency with respect to any of the tax issues affecting the Fund, nor has it obtained an opinion of counsel with respect to any tax issues.

This summary of certain aspects of the Federal income tax treatment of the Fund is based upon the Internal Revenue Code of 1986, as amended (the "Code"), judicial decisions, Treasury Regulations (the "Regulations") and rulings in existence on the date hereof, all of which are subject to change. This summary also does not discuss the impact of various proposals to amend the Code which could change certain of the tax consequences of an investment in the Fund. This summary does not discuss all of the tax consequences that may be relevant to a particular investor or to certain investors subject to special treatment under the Federal income tax laws, such as insurance companies.

EACH PROSPECTIVE SHAREHOLDER SHOULD CONSULT WITH ITS OWN TAX ADVISOR IN ORDER TO FULLY UNDERSTAND THE FEDERAL, STATE, LOCAL AND FOREIGN INCOME AND OTHER TAX CONSEQUENCES OF AN INVESTMENT IN THE FUND.

In addition to the particular matters set forth in this section, tax-exempt organizations should review carefully those sections of the Memorandum regarding liquidity and other financial matters to ascertain whether the investment objectives of the Fund are consistent with their overall investment plans. Each prospective tax-exempt Shareholder is urged to consult its own counsel regarding the acquisition of Shares.

Virtual Currency Tax Implications

On March 25, 2014, the Service issued a notice regarding certain U.S. federal tax implications of transactions in, or transactions that use, virtual currency. According to the Notice, virtual currency is treated as property, not currency, for U.S. federal tax purposes, and "[g]eneral tax principles applicable to property transactions apply to transactions using virtual currency." In part, the Notice provides that the character of gain or loss from the sale or exchange of virtual currency depends on whether the virtual currency is a capital asset in the hands of the taxpayer.

Accordingly, in the U.S., certain transactions in virtual currency are taxable events and subject to information reporting to the Service to the same extent as any other payment made in property.

Additionally, the Service recently issued a revenue ruling regarding certain tax consequences of "hard forks" and "airdrops" of a virtual currency (the "Revenue Ruling"). The Revenue Ruling provides that a taxpayer does not have gross income as a result of a hard fork of a virtual currency the taxpayer owns if the taxpayer does not receive units of a new virtual currency. However, an airdrop of a new virtual currency following a hard fork generally results in ordinary income to the taxpayer if the taxpayer receives units of new virtual currency.

Although the Service has issued the Notice and Revenue Ruling, the U.S. Department of Treasury and the Service may publish future guidance that provides for adverse tax consequences to the Fund and investors in the Fund. Shareholders should be aware that tax laws and Regulations change on an ongoing basis, and that they may be changed with retroactive effect. Moreover, the interpretation and application of tax laws and regulations by certain tax authorities may not be clear, consistent or transparent. As a result, the U.S. Federal tax consequences of investing in the Fund are uncertain.

<u>Tax Treatment of Fund Operations</u>

<u>Classification of the Fund</u>. The Fund intends at no time to have more than 100 partners (within the meaning of Regulations Section 1.7704-1(h)) and to operate as a partnership for Federal tax purposes that is not a publicly traded partnership taxable as a corporation. If it were determined that the Fund should be taxable as a corporation for Federal tax purposes (as a result of changes in the Code, the Regulations or judicial interpretations thereof, a material adverse change in facts, or otherwise), it would be treated as a "passive foreign investment company" and may be treated as a "controlled foreign corporation", which can result in certain adverse tax consequences to some investors, in addition, the Fund would be subject to U.S. income and branch profits tax on its income and gain, if any, which is effectively connected with a U.S. trade or business, in addition to U.S. withholding taxes on certain U.S. source payments.

As a partnership, the Fund generally is not itself subject to Federal income tax (see, however, "Tax Elections; Returns; Tax Audits" below). The Fund files an annual partnership information return with the Service which reports the results of operations. Each Shareholder is required to report separately on its income tax return its distributive share of the Fund's net long-term capital gain or loss, net short-term capital gain or loss and all other items of ordinary income or loss. Each Shareholder is taxed on its distributive share of the Fund's taxable income and gain regardless of whether such Shareholder has received or will receive a distribution from the Fund. As a result, a Shareholder may have a tax liability for any year with respect to income from the Fund, without receiving a corresponding distribution from the Fund.

<u>Contribution of Bitcoin</u>. The Investment Manager may accept contributions of Bitcoin from a Shareholder ("<u>Contributed Bitcoin</u>") in its sole discretion. In such event, a contributing Shareholder will be required to provide to the Fund the acquisition date and tax basis of such Bitcoin as well as any other information regarding such Bitcoin as shall be required by the Investment Manager.

Allocation of Profits and Losses. Under the Articles of Association, the Fund's net capital appreciation or net capital depreciation for each accounting period is allocated among the Shareholders and to their capital accounts without regard to the amount of income or loss actually recognized by the Fund for Federal income tax purposes. The Articles of Association provide that items of income, deduction, gain, loss or credit recognized by the Fund for each fiscal year generally are to be allocated for income tax purposes among the Shareholders pursuant to the principles of Regulations issued under Sections 704(b) and 704(c) of the Code, based upon amounts of the Fund's net capital appreciation or net capital depreciation allocated to each Shareholder's capital account for the current and prior fiscal years. A Shareholder that contributes property other than cash to the Fund will be specially allocated items of income, deduction, gain, loss or credit attributable to such property to the extent of the difference, if any, between the book value and the adjusted tax basis of the property at the time of such contribution. There can be no assurance, however, that the particular methodology of allocations used by the Fund will be accepted by the Service. If such allocations are successfully challenged by the Service, the allocation of the Fund's tax items among the Shareholders may be affected.

Under the Articles of Association, the Investment Manager has the discretion to allocate specially an amount of the Fund's ordinary income and/or capital gain (including short-term capital gain) and deductions, ordinary loss and/or capital loss (including long-term capital loss) for Federal income tax purposes to a redeeming Shareholder to the extent that the Shareholder's capital account exceeds, or is less than, as the case may be, its Federal income tax basis in its Shares. There can be no assurance that, if the Investment Manager makes any such special allocations, the Service will accept such allocations. If such allocations are successfully challenged by the Service, the Fund's tax items allocable to such Shareholder and to the remaining Shareholders would be affected.

Tax Elections; Returns; Tax Audits. The Code generally provides for optional adjustments to the basis of partnership property upon distributions of partnership property to a partner and transfers of partnership interests (including by reason of death) provided that a partnership election has been made pursuant to Section 754. Under the Articles of Association, the Investment Manager, in its sole discretion, may cause the Fund to make such an election. Any such election, once made, cannot be revoked without the Service's consent. As a result of the complexity and added expense of the tax accounting required to implement such an election, the Investment Manager presently does not intend to make such election.

The Investment Manager decides how to report the partnership items on the Fund's tax returns. In certain cases, the Fund may be required to file a statement with the Service disclosing one or more positions taken on its tax return, generally where the tax law is uncertain or a position lacks clear authority. All Shareholders are required under the Code to treat the partnership items consistently on their own returns, unless they file a statement with the Service disclosing the inconsistency. Given the uncertainty and complexity of the tax laws, it is possible that the Service may not agree with the manner in which the Fund's items have been reported. In the event the income tax returns of the Fund are audited by the Service, the tax treatment of the Fund's income and deductions generally is determined at the Fund level in a single proceeding rather than by individual audits of the Shareholders. The Investment Manager, or such other person designated by the Investment Manager to serve as the Fund's partnership representative in the event of an audit by the Service, has considerable authority to make decisions affecting the tax treatment of all Shareholders, including extending the statute of limitations with respect to Fund items and settling any such audit.

An audit adjustment to the Fund's tax return for any tax year beginning after 2017 (a "Prior Year") could result in a tax liability (including interest and penalties) imposed on the Fund for the year during which the adjustment is determined (the "Current Year"). The tax liability generally is determined by using the highest tax rates under the Code applicable to U.S. taxpayers although the Fund may be able to use a lower rate to compute the tax liability by taking into account (to the extent it is the case and the implementing rules permit) that the Fund has certain tax-exempt and foreign investors. Alternatively, the Fund may be able to elect with the Service to pass through such adjustments for any year to the investors who participated in the Fund for the Prior Year, in which case each Prior Year participating investor (or, in certain situations, indirect U.S. owners of a foreign investor that is a "controlled foreign corporation" or a "passive foreign investment company"), and not the Fund, would be responsible for the payment of any tax deficiency, determined after including its share of the adjustments on its tax return for that year. If such an election is made by the Fund, interest on any deficiency will be at a rate that is 2 percentage points higher than the otherwise applicable interest rate on tax underpayments. If such an election is not made, Current Year investors may bear the tax liability (including interest and penalties) arising from audit adjustments at significantly higher rates and in amounts that are unrelated to their Prior Year economic interests in the partnership items that were adjusted.

Mandatory Basis Adjustments. The Fund is generally required to adjust its tax basis in its assets in respect of all Shareholders in cases of partnership distributions that result in a "substantial basis reduction" (i.e., in excess of $250,000) in respect of the Fund's property. The Fund is also required to adjust its tax basis in its assets in respect of a transferee, in the case of a sale or exchange of an interest, or a transfer upon death, when there exists immediately after the transfer a "substantial built-in loss" (i.e., in excess of $250,000) in respect of partnership property or the transferee would be allocated a loss of more than $250,000 upon a disposition of all of the partnership's assets at fair market value. For this reason, the Fund will require (i) a Shareholder who receives a distribution from the Fund in connection with a complete redemption, (ii) a transferee of Shares (including a transferee in case of death) and (iii) any other Shareholder in appropriate circumstances to provide the Fund with information regarding its adjusted tax basis in its Shares.

Tax Consequences to a Redeeming Shareholder

Distributions within Two Years. If a partner who has contributed appreciated property to a partnership receives a distribution of any other property or cash within two years of the contribution, based on the applicable facts and circumstances, the distribution may cause the partner to recognize gain as of the original date of contribution with respect to his or her Contributed Bitcoin under the "disguised sale" provisions of Section 707(a)(2)(B) of the Code. Shareholders should consult their own tax advisors concerning whether such redemptions within two years of the contribution of property should be treated as "disguised sales" for these purposes. Regulations require a Shareholder who does not treat such redemptions as "disguised sales" to disclose such person's tax treatment of those items to the Service.

Distributions of Cash. Except as provided above, a Shareholder receiving a cash liquidating distribution from the Fund, in connection with a complete redemption from the Fund, generally will recognize capital gain or loss to the extent of the difference between the proceeds received by such Shareholder and such Shareholder's adjusted tax basis in its Shares. Such capital gain or loss will be short-term, long-term or some combination of both, depending upon the timing of the Shareholder's contributions to the Fund. However, a redeeming Shareholder will recognize ordinary income to the extent such Shareholder's allocable share of the Fund's "unrealized receivables" exceeds the Shareholder's basis in such unrealized receivables (as determined pursuant to the Regulations). For these purposes, accrued but untaxed market discount, if any, on securities held by the Fund will be treated as an unrealized receivable, with respect to which a redeeming Shareholder would recognize ordinary income. A Shareholder receiving a cash nonliquidating distribution will recognize income in a similar manner only to the extent that the amount of the distribution exceeds such Shareholder's adjusted tax basis in its Shares.

As discussed above, the Articles of Association provide that the Investment Manager may specially allocate items of Fund ordinary income and/or capital gain (including short-term capital gain) and deductions, ordinary loss and/or capital loss (including long-term capital loss) to a redeeming Shareholder to the extent its capital account would otherwise exceed or be less than, as the case may be, its adjusted tax basis in its Shares. Such a special allocation of income or gain may result in the redeeming Shareholder recognizing ordinary income and/or capital gain, which may include short-term capital gain, in the Shareholder's last taxable year in the Fund, thereby reducing the amount of long-term capital gain recognized during the tax year in which it receives its liquidating distribution upon redeeming. Such a special allocation of deduction or loss may result in the redeeming Shareholder recognizing ordinary loss and/or capital loss, which may include long-term capital loss, in the Shareholder's last taxable year in the Fund, thereby reducing the amount of short-term capital loss recognized during the tax year in which it receives its liquidating distribution upon redeeming.

Distributions of Property. Subject to the discussion below, a partner's receipt of a distribution of property from a partnership is generally not taxable. However, under Section 731 of the Code, a distribution consisting of marketable securities generally is treated as a distribution of cash (rather than property) unless the distributing partnership is an "investment partnership" within the meaning of Section 731(c)(3)(C)(i) of the Code and the recipient is an "eligible partner" within the meaning of Section 731(c)(3)(C)(iii) of the Code. If the Fund qualifies as an "investment partnership" and a Shareholder is an "eligible partner," which term should include a Shareholder whose contributions to the Fund consisted solely of cash, the rule treating a distribution of property as a distribution of cash would not apply. In the absence of guidance, it is not clear whether Bitcoin are treated as "marketable securities" for these purposes, and whether the Fund will qualify as an "investment partnership."

Effect on Contributing Shareholders of Distribution of Bitcoin to Contributing Shareholder within Seven Years of the Date of Contribution. If a Shareholder contributes appreciated Bitcoin to the Fund and, within seven years of the date of contribution, that Shareholder receives a distribution of any property other than such Shareholder's Contributed Bitcoin, such Shareholder generally will be required to recognize gain upon the receipt of such other property. The amount of the gain is equal to the least of (a) the excess of the fair market value of the distributed property over the adjusted tax basis of such Shareholder's interest in the

Fund immediately before the distribution, reduced by the amount of money received in the distribution; (b) the excess of the fair market value of such Shareholder's Contributed Bitcoin over their adjusted tax basis at the time they were contributed to the Fund or (c) the excess of the fair market value of such Shareholder's Contributed Bitcoin over their adjusted tax basis in the hands of the Fund, at the time of the distribution of such other property. Shareholders should note that, in the event of a distribution of Bitcoin to a Shareholder, the Fund may not be able to distribute such Shareholder's Contributed Bitcoin to the redeeming Shareholders.

Effect on Contributing Shareholders of Distribution of Bitcoin to "Non-Contributing" Shareholder within Seven Years of the Date of Contribution. If Contributed Bitcoin are distributed within seven years of the date of contribution to any Shareholder other than the Shareholder who contributed such Bitcoin ("Shifted Bitcoin"), the contributing Shareholder must generally recognize a taxable gain or loss in the year of distribution. The amount of such gain or loss would generally equal the lesser of (a) the difference between the fair market value of the Shifted Bitcoin at the time such Shifted Bitcoin had been contributed to the Fund and the contributing Shareholder's tax basis in such Shifted Bitcoin or (b) the difference between the fair market value of the Shifted Bitcoin and their adjusted tax basis in the hands of the Fund at the time of their distribution.

Tax Treatment of Fund Investments

In General. The Fund expects to act as an investor, and not as a dealer, with respect to its transactions. An investor is a person who buys and sells assets for its own account. A dealer, on the other hand, is a person who purchases assets for resale to customers rather than for investment or speculation.

Generally, the gains and losses realized by an investor on the sale of capital assets are capital gains and losses. As noted earlier, the Notice issued by the Service provides that a virtual currency, such as Bitcoin, is treated as property, not currency, for U.S. federal income tax purposes, and that general tax principles applicable to property transactions apply to transactions using Bitcoin. As such, the Fund intends to treat Bitcoin as capital assets for U.S. federal income tax purposes, including for tax reporting purposes.

Capital gains and losses recognized by the Fund may be long-term or short-term depending, in general, upon the length of time the Fund maintains a particular investment position and, in some cases, upon the nature of the transaction. Property held for more than one year generally will be eligible for long-term capital gain or loss treatment. The Fund may also realize ordinary income and losses with respect to its transactions.

The income tax rate for corporations is 21%. Capital losses of a corporate taxpayer may be offset only against capital gains, but unused capital losses may be carried back three years (subject to certain limitations) and carried forward five years.

The maximum ordinary income tax rate for individuals is 37%[1] and, in general, the maximum individual income tax rate for "Qualified Dividends"[2] and long-term capital gains is 20% (unless the taxpayer elects to be taxed at ordinary rates - see "Limitation on Deductibility of Interest and Short Sale Expenses" below). The excess of capital losses over capital gains may be offset against the ordinary income of an individual taxpayer, subject to an annual deduction limitation of $3,000. Capital losses of an individual taxpayer may generally be carried forward to succeeding tax years to offset capital gains and then ordinary income (subject to the $3,000 annual limitation). (See, however, "Limitation on Deductibility of Net Losses" below.)

An individual may be entitled to deduct up to 20% of such individual's "qualified business income" each year. However, it is not anticipated that income from the Fund will constitute qualified business income.

In addition, individuals, estates and trusts are subject to a Medicare tax of 3.8% on net investment income ("NII") (or undistributed NII, in the case of estates and trusts) for each such taxable year, with such tax applying to the lesser of such income or the excess of such person's adjusted gross income (with certain adjustments) over a specified amount.[3] NII includes net income from interest, dividends, annuities, royalties and rents and net gain attributable to the disposition of investment property. It is generally anticipated that net income and gain attributable to an investment in the Fund will be included in an investor's NII subject to this Medicare tax. However, the calculation of NII for purposes of the Medicare tax and taxable income for purposes of the regular income tax may be different. Furthermore, the Medicare tax and the regular income tax may be due in different taxable years with respect to the same income. The application of the tax (and the availability of particular elections) is quite complex. Shareholders are urged to consult their tax advisers regarding the consequences of these rules in respect of their investments.

The Fund may engage in Bitcoin lending transactions. The tax treatment of lending Bitcoin is uncertain. While, the Fund expects the lending of Bitcoin not to be treated as a taxable disposition of such Bitcoin, there is no assurance that the Service will agree. If the lending of Bitcoin were determined to be treated as taxable dispositions of such Bitcoin, the Fund generally would recognize any built-in gain or loss in such Bitcoin.

The Fund may also realize ordinary income and losses with respect to its transactions. As described above, the Revenue Ruling provides that airdrops of virtual currency may result in ordinary income to the recipient. If the Fund were to receive an airdrop of virtual currency in respect of its Bitcoin, the Fund generally will recognize ordinary income with respect

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1 The maximum rate for ordinary income for individuals is scheduled to increase to 39.6% in 2026.

2 A "Qualified Dividend" is generally a dividend from certain domestic corporations, and from certain foreign corporations that are either eligible for the benefits of a comprehensive income tax treaty with the United States or are readily tradable on an established capital assets market in the United States. Shares must be held for certain holding periods in order for a dividend thereon to be a Qualified Dividend.

3 The amount is $250,000 for married individuals filing jointly, $125,000 for married individuals filing separately, $200,000 for other individuals and the dollar amount at which the highest income tax bracket for estates and trusts begins.

thereto. Additionally, fees or other payments received in consideration for the Fund lending Bitcoin generally will be taxed as ordinary income.

Limitation on Deductibility of Interest Expenses. For noncorporate taxpayers, Section 163(d) of the Code limits the deduction for "investment interest" (i.e., interest expenses for "indebtedness properly allocable to property held for investment"). Investment interest is not deductible in the current year to the extent that it exceeds the taxpayer's "net investment income," consisting of net gain and ordinary income derived from investments in the current year less certain directly connected expenses (other than interest or short sale expenses). For this purpose, Qualified Dividends and long-term capital gains are excluded from net investment income unless the taxpayer elects to pay tax on such amounts at ordinary income tax rates.

For purposes of this provision, the Fund's activities will be treated as giving rise to investment income for a Shareholder, and the investment interest limitation would apply to a noncorporate Shareholder's share of the interest and short sale expenses attributable to the Fund's operation. Such noncorporate Shareholder would be denied a deduction for all or part of that portion of its distributive share of the Fund's ordinary losses attributable to interest and short sale expenses unless it had sufficient investment income from all sources including the Fund. A Shareholder that could not deduct losses currently as a result of the application of Section 163(d) would be entitled to carry forward such losses to future years, subject to the same limitation. The investment interest limitation would also apply to interest paid by a noncorporate Shareholder on money borrowed to finance its investment in the Fund. Potential investors are advised to consult with their own tax advisors with respect to the application of the investment interest limitation in their particular tax situations.

Limitation on Deductibility of Business Interest Expense. Section 163(j) of the Code limits the deduction of business interest expense attributable to a trade or business generally to the sum of the taxpayer's (x) business interest income and (y) 30% of adjusted taxable income relating to a trade or business (calculated by excluding business interest expense and business interest income).

"Business interest expense" includes, among other items, substitute interest payments made in connection with a securities lending or repurchase agreement that is not entered into in connection with the ordinary course of the taxpayer's trade or business. Any business interest expense not deductible pursuant to the foregoing limitation is treated as business interest expense of the taxpayer that carries forward to succeeding taxable years, subject to the same limitation.

The Fund expects that Shareholders for whom the investment interest rules apply in respect of their interest in the Fund, such as certain noncorporate Shareholders (see "Limitation on Deductibility of Interest Expenses" above), generally will not be treated as subject to the business interest expense limitations determined by the Fund, other than with respect to business interest expense passed through to the Fund by an underlying partnership, if any, that is engaged in certain trades or businesses.

The determination of what constitutes business interest expense in respect of the Fund's operations is determined at the partnership level. As described above, the Fund does not expect to be a trader with respect to its transactions. Nevertheless, this limitation will still be applicable to corporate investors in the Fund.

Potential investors are advised to consult with their own tax advisors with respect to the application of the business interest expense limitation to their particular tax situations.

Deductibility of Fund Investment Expenditures and Certain Other Expenditures. Investment expenses (e.g., investment advisory fees) of an individual, trust or estate are not deductible. For taxable years beginning after 2025, such expenses would be deductible only to the extent they exceed 2% of adjusted gross income, would be further restricted in their deductibility for individuals with an adjusted gross income in excess of a specified amount and would not be deductible in calculating its alternative minimum tax liability.

Pursuant to Temporary Regulations issued by the Treasury Department, these limitations on deductibility will likely apply to a noncorporate Shareholder's share of certain expenses of the Fund including the Management Fee, the Realization Fee and the fee paid to the Administrator.

The consequences of these limitations will vary depending upon the particular tax situation of each taxpayer. Accordingly, noncorporate Shareholders should consult their tax advisors with respect to the application of these limitations.

A Shareholder will not be allowed to deduct syndication expenses, including placement fees paid by such Shareholder or the Fund. Any such amounts will be included in the Shareholder's adjusted tax basis for its Shares.

Application of Rules for Income and Losses from Passive Activities. The Code restricts the deductibility of losses from a "passive activity" against certain income which is not derived from a passive activity. This restriction applies to individuals, personal service corporations and certain closely held corporations. Pursuant to Temporary Regulations issued by the Treasury Department, income or loss from the Fund's investment and trading activity, if any, generally will not constitute income or loss from a passive activity. Therefore, passive losses from other sources generally could not be deducted against a Shareholder's share of such income and gain from the Fund.

Limitation on Deductibility of Net Losses. In the case of a noncorporate taxpayer, any net business loss for any taxable year beginning during the period 2021 through 2025 may not be used to offset nonbusiness income in excess of $250,000 ($500,000 in the case of a married couple filing jointly). Inasmuch as the Fund does not expect to be a trader, a noncorporate Shareholder's trade or business losses incurred during a year outside of the Fund (other than capital loss) generally could not be deducted against its share of the Fund's net income for such year. Even if the Fund is not considered to be a trader, any ordinary trading losses incurred by a partnership in which the Fund invests, if any, will be subject to the same limitations when allocated to a noncorporate Shareholder.

Application of Basis and "At Risk" Limitations on Deductions. The amount of any loss of the Fund that a Shareholder is entitled to include in its income tax return is limited to its adjusted tax basis in its Shares as of the end of the Fund's taxable year in which such loss occurred. Generally, a Shareholder's adjusted tax basis for its Shares is equal to the amount paid for such

Shares, increased by the sum of (i) its share of the Fund's liabilities, as determined for Federal income tax purposes, and (ii) its distributive share of the Fund's realized income and gains, and decreased (but not below zero) by the sum of (i) distributions (including decreases in its share of Fund liabilities) made by the Fund to such Shareholder and (ii) such Shareholder's distributive share of the Fund's realized losses and expenses.

Similarly, a Shareholder that is subject to the "at risk" limitations (generally, noncorporate taxpayers and closely held corporations) may not deduct losses of the Fund to the extent that they exceed the amount such Shareholder has "at risk" with respect to its Shares at the end of the year. The amount that a Shareholder has "at risk" will generally be the same as its adjusted basis as described above, except that it will generally not include any amount attributable to liabilities of the Fund or any amount borrowed by the Shareholder on a non-recourse basis.

Losses denied under the basis or "at risk" limitations are suspended and may be carried forward to subsequent taxable years, subject to these and other applicable limitations.

U.S. Withholding Taxes

Certain payments, including fees paid in connection with Bitcoin lending transactions, received by the Fund from sources within the United States may be subject to withholding taxes imposed by the United States. The Shareholders will be informed by the Fund as to their proportionate share of the U.S. taxes paid by the Fund, if any, which they will be required to include in their income. The Shareholders should be entitled to claim an unrestricted credit or refund for their share of such U.S. taxes in computing their own Federal income tax liability.

Reporting Requirements

Regulations generally impose an information reporting requirement on a U.S. person's direct and indirect contributions of cash or property to a foreign partnership such as the Fund where, (i) immediately after the contribution, the U.S. person owns (directly, indirectly or by attribution) at least a 10% interest in the foreign partnership or (ii) the value of the cash and/or property transferred during the twelve-month period ending on the date of the contribution by the transferor (or any related person) exceeds $100,000. In addition, to the extent not included in the reporting requirement described above, a U.S. person is required to file an information return with the Service (a) if such person directly acquires or disposes of at least a 10% interest in a foreign partnership such as the Fund (e.g., from 11% to 21% or from 21% to 11%), (b) if such person who did not own a 10% or greater direct interest in the partnership acquires (directly and/or as a result of redemptions by other partners) an interest and, as a result of the acquisition, the person owns a 10% or greater direct interest in the partnership (e.g., from 9% to 11%); (c) any time such person who owns a 10% or greater direct interest in the partnership disposes (directly and/or as a result of the issuance of interests to other partners) of an interest and, as a result of the disposition, the person owns less than a 10% direct interest (e.g., from 11% to 8%); or (d) if such person's direct proportional interest has increased or decreased by at least the equivalent of a 10% interest in the partnership. Furthermore, if a U.S. person was required to report a transfer to a foreign partnership of appreciated property under the first sentence of this paragraph, and the foreign partnership disposes of the property while such U.S. person remains a direct or indirect partner, that U.S. person must report the disposition by the partnership.

Regulations also generally impose an annual reporting requirement on U.S. persons owning, at any time during the taxable year, 10% or more of the profits or capital of a "U.S. controlled" foreign partnership. For purposes of this provision, a foreign partnership is "U.S. controlled" if one or more U.S. persons owning 10% or more of the profits or capital of the partnership own, in the aggregate, more than 50% of the profits or capital of the partnership. Alternatively, if one U.S. person owns, at any time during the taxable year, more than 50% of the profits or capital of a foreign partnership, such person, rather than the 10% partners (if any), is required to comply with the annual reporting requirement. For purposes of this paragraph, "ownership" of a partnership interest includes interests owned directly, indirectly and by attribution.

U.S. individuals, as well as certain closely held U.S. entities where at least 50% of such entities' assets are, or at least 50% of their gross income comes from, passive assets such as an investment in the Fund, will generally be required to make additional tax filings if their aggregate investment in foreign financial accounts, including non-U.S. entities such as the Fund, exceeds $50,000. Such filing requirements may be extended to additional U.S. entities who are deemed to be formed or availed for the purpose of making investments in non-U.S. entities such as the Fund.

Identity and Reporting of Beneficial Ownership; Withholding on Certain Payments

In order to avoid a U.S. withholding tax of 30% on certain payments (which might in the future include payments of gross proceeds) made with respect to certain actual and deemed U.S. investments, the Fund has registered with the Service and generally will be required to identify, and report information with respect to, certain direct and indirect U.S. account holders (including debtholders and equityholders). The Cayman Islands has signed the US IGA to give effect to the foregoing withholding and reporting rules. So long as the Fund complies with the US IGA and the enabling Cayman Islands legislation, it will not be subject to the related U.S. withholding tax.

A non-U.S. investor in the Fund will generally be required to provide to the Fund information which identifies its direct and indirect U.S. ownership. Under the US IGA, any such information provided to the Fund and certain financial information related to such investor's investment in the Fund will be shared with the Cayman TIA. The Cayman TIA will exchange the information reported to it with the Service annually on an automatic basis. A non-U.S. investor that is a "foreign financial institution" within the meaning of Section 1471(d)(4) of the IRC will generally be required to timely register with the Service and agree to identify, and report information with respect to, certain of its own direct and indirect U.S. account holders (including debtholders and equityholders). A non-U.S. investor who fails to provide such information to the Fund or timely register and agree to identify, and report information with respect to, such account holders (as applicable) may be subject to the 30% withholding tax with respect to its share of any such payments attributable to actual and deemed U.S. investments of the Fund, and the Fund or its agents may take any action in relation to an investor's Shares or redemption proceeds to ensure that such withholding is economically borne by the relevant investor whose failure to provide the necessary information or comply with such requirements gave rise to the withholding. Shareholders should consult their own tax advisors regarding the possible implications of these rules on their investments in the Fund.

The foregoing discussion is only a brief summary of certain information reporting and withholding requirements. Substantial penalties may apply if the required reports are not made on time. U.S. Shareholders are urged to consult their own tax advisors concerning these requirements as they relate to their investment in the Fund.

Foreign Taxes

The Fund may be subject to capital gains taxes in some of the foreign countries where it purchases and sells assets. Tax treaties between certain countries and the United States may reduce or eliminate such taxes with respect to the Fund's U.S. Shareholders. It is impossible to predict in advance the rate of foreign tax the Fund will pay since the amount of the Fund's assets to be invested in various countries is not known.

Shareholders will be informed by the Fund as to their proportionate share of the foreign taxes paid by the Fund which they will be required to include in their income. Shareholders generally will be entitled to claim either a credit (subject to the limitations discussed below and provided that, in the case of dividends, the foreign stock is held for the requisite holding period) or, if they itemize their deductions, a deduction (subject to the limitations generally applicable to deductions) for their share of such foreign taxes in computing their Federal income taxes. A Shareholder that is tax exempt will not ordinarily benefit from such credit or deduction.

Generally, a credit for foreign taxes is subject to the limitation that it may not exceed the Shareholder's Federal tax (before the credit) attributable to its total foreign source taxable income. Generally, the source of gain and loss realized upon the sale of personal property will be based on the residence of the seller. In the case of a partnership, the determining factor is the residence of the partner. Thus, absent a tax treaty to the contrary, the gains and losses from the sale of assets allocable to a Shareholder that is a U.S. resident generally will be treated as derived from U.S. sources (even though the assets are sold in foreign countries). For purposes of the foreign tax credit limitation calculation, investors entitled to the reduced tax rates on Qualified Dividends and long-term capital gains described above (see "Tax Treatment of Fund Investments – In General"), must adjust their foreign tax credit limitation calculation to take into account the preferential tax rate on such income to the extent it is derived from foreign sources. Certain currency fluctuation gains, including fluctuation gains from foreign currency denominated assets, will also be treated as ordinary income derived from U.S. sources.

The limitation on the foreign tax credit generally is applied separately to foreign source passive income, such as dividends and interest. In addition, for foreign tax credit limitation purposes, the amount of a Shareholder's foreign source income is reduced by various deductions that are allocated and/or apportioned to such foreign source income. One such deduction is interest expense, a portion of which will generally reduce the foreign source income of any Shareholder who owns (directly or indirectly) foreign assets. For these purposes, foreign assets owned by the Fund will be treated as owned by the investors in the Fund and indebtedness incurred by the Fund will be treated as incurred by investors in the Fund.

Because of these limitations, Shareholders may be unable to claim a credit for the full amount of their proportionate share of the foreign taxes paid by the Fund. In addition, a foreign tax credit generally will not be available to offset the Medicare tax on NII. The foregoing is only a general description of the foreign tax credit under current law. Moreover, since the availability of a credit or deduction depends on the particular circumstances of each Shareholder, Shareholders are advised to consult their own tax advisors.

Unrelated Business Taxable Income

Generally, an exempt organization is exempt from Federal income tax on its passive investment income, such as dividends, interest and capital gains, whether realized by the organization directly or indirectly through a partnership in which it is a partner.

This general exemption from tax does not apply to the "unrelated business taxable income" ("UBTI") of an exempt organization. Generally, except as noted above with respect to certain categories of exempt trading activity, UBTI includes income or gain derived (either directly or through partnerships) from a trade or business, the conduct of which is substantially unrelated to the exercise or performance of the organization's exempt purpose or function. Separate calculations are made for each unrelated trade or business of the exempt organization, with losses incurred during taxable years beginning after 2017 usable only against the applicable unrelated trade or business and not against all UBTI generally. UBTI also includes "unrelated debt-financed income," which generally consists of (i) income derived by an exempt organization (directly or through a partnership) from income-producing property with respect to which there is "acquisition indebtedness" at any time during the taxable year, and (ii) gains derived by an exempt organization (directly or through a partnership) from the disposition of property with respect to which there is "acquisition indebtedness" at any time during the twelve-month period ending with the date of such disposition.

Based upon the limited guidance received from the Service, it is unclear to what extent investment in virtual currency might result in UBTI. As a result, if the Fund receives an airdrop of virtual currency, it is possible that such airdrop may result in UBTI. Additionally, fees paid to the Fund in connection with the lending of Bitcoin may also generate UBTI. Investors are advised to consult their own tax advisors with respect to the foregoing.

The Fund may incur "acquisition indebtedness" with respect to certain of its transactions. To the extent the Fund recognizes income (i.e., dividends and interest) from assets with respect to which there is "acquisition indebtedness" during a taxable year, the percentage of such income which will be treated as UBTI generally will be based on the percentage which the "average acquisition indebtedness" incurred with respect to such assets is of the "average amount of the adjusted basis" of such capital assets during the taxable year.

To the extent the Fund recognizes gain from assets with respect to which there is "acquisition indebtedness" at any time during the twelve-month period ending with the date of their disposition, the percentage of such gain which will be treated as UBTI will be based on the percentage which the highest amount of such "acquisition indebtedness" is of the "average amount of the adjusted basis" of such assets during the taxable year. In determining the unrelated debt-financed income of the Fund, an allocable portion of deductions directly connected with the Fund's debt-financed property is taken into account. Thus, for instance, a percentage of losses from debt-financed assets (based on the debt/basis percentage calculation described above) would offset gains treated as UBTI.

Since the calculation of the Fund's "unrelated debt-financed income" is complex and will depend in large part on the amount of leverage, if any, used by the Fund from time to time,[4] it is impossible to predict what percentage of the Fund's income and gains will be treated as UBTI for a Shareholder which is an exempt organization. With respect to losses incurred during taxable years beginning after 2017, an exempt organization's share of the income or gains of the Fund which is treated as UBTI may not be offset by losses of the exempt organization either from the Fund or otherwise, unless such losses are treated as attributable to the unrelated trade or business.

To the extent that the Fund generates UBTI, the applicable Federal tax rate for such a Shareholder generally would be either the corporate or trust tax rate depending upon the nature of the particular exempt organization. An exempt organization may be required to support, to the satisfaction of the Service, the method used to calculate its UBTI. The Fund will be required to report to a Shareholder which is an exempt organization information as to the portion, if any, of its income and gains from the Fund for each year which will be treated as UBTI. The calculation of such amount with respect to transactions entered into by the Fund is highly complex, and there is no assurance that the Fund's calculation of UBTI will be accepted by the Service.

In general, if UBTI is allocated to an exempt organization such as a qualified retirement plan or a private foundation, the portion of the Fund's income and gains which is not treated as UBTI will continue to be exempt from tax, as will the organization's income and gains from other investments which are not treated as UBTI. Therefore, the possibility of realizing UBTI from its investment in the Fund generally should not affect the tax-exempt status of such an exempt organization.[5] However, a charitable remainder trust will be subject to a 100% excise tax on any UBTI under Section 664(c) of the Code. A title-holding company will not be exempt from tax if it has certain types of UBTI. Moreover, the charitable contribution deduction for a trust under Section 642(c) of the Code may be limited for any year in which the trust has UBTI. A prospective investor should consult its tax advisor with respect to the tax consequences of receiving UBTI from the Fund.

Certain Issues Pertaining to Specific Exempt Organizations

Private Foundations. Private foundations and their managers are subject to excise taxes if they invest "any amount in such a manner as to jeopardize the carrying out of any of the foundation's exempt purposes." This rule requires a foundation manager, in making an investment, to exercise "ordinary business care and prudence" under the facts and circumstances prevailing at the time of making the investment, in providing for the short-term and long-term needs of the foundation to carry out its exempt purposes. The factors which a foundation manager may take into account in assessing an investment include the expected rate of return (both income and capital

[4] The calculation of a particular exempt organization's UBTI would also be affected if it incurs indebtedness to finance its investment in the Fund. An exempt organization is required to make estimated tax payments with respect to its UBTI.

[5] Certain exempt organizations which realize UBTI in a taxable year will not constitute "qualified organizations" for purposes of Section 514(c)(9)(B)(vi)(I) of the Code, pursuant to which, in limited circumstances, income from certain real estate partnerships in which such organizations invest might be treated as exempt from UBTI. A prospective tax-exempt Shareholder should consult its tax advisor in this regard.

appreciation), the risks of rising and falling price levels, and the need for diversification within the foundation's portfolio.

In order to avoid the imposition of an excise tax, a private foundation may be required to distribute on an annual basis its "distributable amount," which includes, among other things, the private foundation's "minimum investment return," defined as 5% of the excess of the fair market value of its nonfunctionally related assets (assets not used or held for use in carrying out the foundation's exempt purposes), over certain indebtedness incurred by the foundation in connection with such assets. It appears that a foundation's investment in the Fund would most probably be classified as a nonfunctionally related asset. A determination that an interest in the Fund is a nonfunctionally related asset could conceivably cause cash flow problems for a prospective Shareholder which is a private foundation. Such an organization could be required to make distributions in an amount determined by reference to unrealized appreciation in the value of its interest in the Fund. Of course, this factor would create less of a problem to the extent that the value of the investment in the Fund is not significant in relation to the value of other assets held by a foundation.

In some instances, an investment in the Fund by a private foundation may be prohibited by the "excess business holdings" provisions of the Code. For example, if a private foundation (either directly or together with a "disqualified person") acquires more than 20% of the capital interest or profits interest of the Fund, the private foundation may be considered to have "excess business holdings." If this occurs, such foundation may be required to divest itself of its interest in the Fund in order to avoid the imposition of an excise tax. However, the excise tax will not apply if at least 95% of the gross income from the Fund is "passive" within the applicable provisions of the Code and Regulations. There can be no assurance that the Fund will meet such 95% gross income test.

A substantial percentage of investments of certain "private operating foundations" may be restricted to assets directly devoted to their tax-exempt purposes. Otherwise, generally, rules similar to those discussed above govern their operations.

With certain exceptions, tax-exempt organizations which are private foundations are subject to a 1.39% Federal excise tax on their "net investment income." A private foundation will be required to make payments of estimated tax with respect to this excise tax.

<u>Private Colleges and Universities</u>. Net investment income of certain private colleges and universities is subject to a 1.4% tax. Such income is calculated in the same manner in which private foundations calculate their net investment income.

<u>Qualified Retirement Plans</u>. Employee benefit plans subject to the provisions of ERISA, Individual Retirement Accounts and Keogh Plans should consult their counsel as to the implications of such an investment under ERISA and the Code.

<u>Endowment Funds</u>. Investment managers of endowment funds should consider whether the acquisition of Shares is legally permissible. This is not a matter of Federal law, but is determined under state statutes. It should be noted, however, that under the Uniform Prudent Management of Institutional Funds Act, which has been adopted, in various forms, by a large

number of states, participation in investment partnerships or similar organizations in which funds are commingled and investment determinations are made by persons other than the governing board of the endowment fund is allowed.

Certain Clubs and Trusts. Social clubs, voluntary employees' beneficiary associations and supplemental unemployment benefit trusts that are exempt from Federal income taxation under Sections 501(c)(7), (c)(9) and (c)(17), respectively, of the Code are subject to special UBTI rules. These rules generally require such tax-exempt organizations to characterize income that would not otherwise be treated as UBTI (including income earned by the Fund) as UBTI. Such tax-exempt organizations are advised to consult their tax advisors concerning these rules and their application to this investment.

Excise Tax on Certain Reportable Transactions

A tax-exempt entity (including a state or local government or its political subdivision) may be subject to an excise tax equal to the greater of (i) one hundred percent (100%) of the net income or (ii) seventy five percent (75%) of the proceeds, attributable to certain "reportable transactions", including "listed transactions", in which it participates. Under Regulations, these rules should not apply to a tax-exempt Shareholder's Shares if such investor's tax-exempt status does not facilitate the Fund's participation, if any, in such transactions, unless otherwise provided in future guidance. Tax-exempt investors should discuss with their own advisors the applicability of these rules to their investment in the Fund. (See "Tax Shelter Reporting Requirements" below.)

Certain Reporting Obligations

Certain U.S. persons ("potential filers") who have an interest in a foreign financial account during a calendar year are generally required to file FinCEN Form 114 (an "FBAR") with respect to such account. Failure to file a required FBAR may result in civil and criminal penalties. Under existing regulatory guidance, potential filers who do not own (directly or indirectly) more than 50% of the interests in the Fund's profits or capital, generally are not obligated to file an FBAR with respect to an investment in the Fund. However, potential filers should consult their own advisors regarding the current status of this guidance.

Tax Shelter Reporting Requirements

The Regulations require the Fund to complete and file Form 8886 ("Reportable Transaction Disclosure Statement") with its tax return for any taxable year in which the Fund participates in a "reportable transaction." Additionally, each Shareholder treated as participating in a reportable transaction of the Fund is generally required to file Form 8886 with its tax return (or, in certain cases, within 60 days of the return's due date). If the Service designates a transaction as a reportable transaction after the filing of a taxpayer's tax return for the year in which the Fund or a Shareholder participated in the transaction, the Fund and/or such Shareholder may have to file Form 8886 with respect to that transaction within 90 days after the Service makes the designation. The Fund and any such Shareholder, respectively, must also submit a copy of the completed form with the Service's Office of Tax Shelter Analysis. The Fund intends to notify the Shareholders that it believes (based on information available to the Fund) are required to report a transaction of the Fund, and intends to provide such Shareholders with any available information needed to complete and submit Form 8886 with respect to the Fund's transactions. In certain situations, there may also be a requirement that a list be maintained of persons participating in such reportable transactions, which could be made available to the Service at its request.

A Shareholder's recognition of a loss upon its disposition of an interest in the Fund could also constitute a "reportable transaction" for such Shareholder, requiring such Shareholder to file Form 8886.

A significant penalty is imposed on taxpayers who participate in a "reportable transaction" and fail to make the required disclosure. The maximum penalty is $10,000 for natural persons and $50,000 for other persons (increased to $100,000 and $200,000, respectively, if the reportable transaction is a "listed transaction"). Investors should consult with their own advisors concerning the application of these reporting obligations to their specific situations.

State and Local Taxation

In addition to the Federal income tax consequences described above, prospective investors should consider potential state and local tax consequences of an investment in the Fund. State and local laws often differ from Federal income tax laws with respect to the treatment of specific items of income, gain, loss, deduction and credit. A Shareholder's distributive share of the taxable income or loss of the Fund generally will be required to be included in determining its reportable income for state and local tax purposes in the jurisdiction in which it is a resident. To the extent the Fund is engaged in a trade or business, a Shareholder's share of the Fund's income from that trade or business that is sourced to a particular jurisdiction may cause such member to be taxed in that jurisdiction and may cause such member to file tax returns in such jurisdiction. Prospective investors should consult their tax advisors with respect to the availability of a credit for any such tax in the jurisdiction in which that Shareholder is a resident.

The tax laws of various states and localities limit or eliminate the deductibility of itemized deductions for certain taxpayers. These limitations will likely apply to a Shareholder's share of some or all of the Fund's expenses, including interest expense. Prospective investors are urged to consult their tax advisors with respect to the impact of these provisions on the deductibility of certain itemized deductions, including interest expense, on their tax liabilities in the jurisdictions in which they are resident.

One or more states may impose reporting requirements on the Fund and/or its Shareholders in a manner similar to that described above in "Tax Shelter Reporting Requirements." Investors should consult with their own advisors as to the applicability of such rules in jurisdictions which may require or impose a filing requirement.

Cayman Islands Taxation

The Fund has received an undertaking as of June 22, 2004 from the Governor in Cabinet of the Cayman Islands to the effect that, for a period of 20 years from the date of such undertaking (a) no law which is thereafter enacted in the Cayman Islands imposing any tax to be levied on the profits, income, gains or appreciations shall apply to the Fund or its operations, and

(b) no such tax nor any tax in the nature of estate duty or inheritance tax will be payable by the Fund (i) on or in respect of the shares, debentures or other obligations of the Fund, or (ii) by way of the withholding in whole or in part of any relevant payment as defined in Section 6(3) of the Tax Concessions Act (as amended) of the Cayman Islands. No capital or stamp duties are levied in the Cayman Islands on the issue, transfer or redemption of Shares. An annual registration fee will be payable by the Fund to the Cayman Islands government which will be calculated by reference to the nominal amount of its authorized capital.

Cayman Islands – Automatic Exchange of Financial Account Information

The Cayman Islands has signed an inter-governmental agreement to improve international tax compliance and the exchange of information with the United States (the "US IGA"). The Cayman Islands has also signed, along with over 100 other countries, a multilateral competent authority agreement to implement the Organisation for Economic Cooperation and Development's Standard for Automatic Exchange of Financial Account Information – Common Reporting Standard (the "CRS" and together with the US IGA "AEOI").

The Cayman Islands has issued regulations to give effect to the AEOI regime (the "AEOI Regulations"). Pursuant to the AEOI Regulations, the Cayman TIA has published guidance notes on the application of the US IGA and the CRS.

All Cayman Islands "Financial Institutions" are required to comply with the registration, due diligence and reporting requirements of the AEOI Regulations, unless they are able to rely on an exemption that allows them to become a "Non-Reporting Financial Institution" (as defined in the relevant AEOI Regulations) with respect to one or more of the AEOI regimes, in which case only the registration requirement would apply under the CRS. The Fund does not propose to rely on any reporting exemption and therefore intends to comply with the requirements of the AEOI Regulations.

The AEOI Regulations require the Fund to, amongst other things, (i) register with the Service, (ii) register with the Cayman TIA, and thereby notify the Cayman TIA of its status as a "Reporting Financial Institution"; (iii) adopt and implement written policies and procedures setting out how it will address its obligations under the CRS; (iv) conduct due diligence on its accounts to identify whether any such accounts are considered "Reportable Accounts"; and (v) annually report information on such Reportable Accounts to the Cayman TIA. The Cayman TIA will transmit the information reported to it to the overseas fiscal authority relevant to a Reportable Account (e.g., the Service in the case of a US Reportable Account) annually on an automatic basis.

For details on the related U.S. tax withholding and reporting regime, see "Identity and Reporting of Beneficial Ownership; Withholding on Certain Payments" above.

By investing in the Fund and/or continuing to invest in the Fund, investors shall be deemed to acknowledge that further information may need to be provided to the Fund, the Fund's compliance with the AEOI Regulations may result in the disclosure of investor information, and investor information may be exchanged with overseas fiscal authorities. Where an investor fails to provide any requested information (regardless of the consequences), the Fund reserves the right to take any action and/or pursue all remedies at its disposal including, without limitation, compulsory redemption or withdrawal of the investor concerned.

Foreign Shareholders

The Fund does not expect its investment activities to constitute a trade or business in the United States, in which case foreign Shareholders would not be subject to U.S. tax. However, if the Fund were to be treated as engaged in a United States trade or business (either directly or indirectly through pass-through entities that are so engaged), income and gain effectively connected with the conduct of that trade or business allocated to a foreign Shareholder would subject such person to Federal income tax on that income on a net basis at the same rates that are generally applicable to that particular type of investor which is a U.S. person. The Fund is required to withhold U.S. income tax with respect to each foreign Shareholder's share of the Fund's effectively connected income. The amount withheld is reportable as a tax credit on the U.S. income tax return that such foreign Shareholder is required to file. Moreover, effectively connected earnings from the Fund which are allocated to a foreign corporate Shareholder and are not reinvested in a United States trade or business may be subject to a "branch profits tax."

Section 864(b)(2) of the Code provides a safe harbor (the "Safe Harbor") applicable to a non-U.S. Person (other than a dealer in securities) that engages in the U.S. in trading commodities for its own account pursuant to which such U.S. Person will not be deemed to be engaged in a U.S. trade or business if the "commodities are of a kind customarily dealt in on an organized commodity exchange and if the transaction is of a kind customarily consummated at such place." The CFTC has taken the position that Bitcoin meets the definition of a commodity under section 1a(9) of the Commodity Exchange Act. Moreover, Bitcoin futures are traded on both the Chicago Mercantile Exchange (CME) and Chicago Board Options Exchange (CBOE), two CFTC-registered and regulated commodity exchanges. The Service, however, has not issued guidance as to whether or not Bitcoin is considered a commodity for purposes of the Safe Harbor. Accordingly, even if the Service were to assert that the activities of the Fund (including as a result of the Fund's participation in Bitcoin lending transactions) do constitute a trade or business of trading in virtual currency, it is possible that such trading could satisfy the requirements of the Safe Harbor.

Withholding taxes, if any, would be imposed on a non-U.S. Member's share of certain of the Fund's U.S. source gross income arising from safe harbor activities, and certain other income (e.g., fees paid in connection with Bitcoin lending transactions), unless an exception were applicable to reduce or eliminate such withholding.

If a foreign individual owns a Fund interest at the time of his death, the foreign individual's interest in the Fund or its assets may be subject to U.S. estate taxation to the extent of the Fund's direct or indirect U.S. assets unless provided otherwise by applicable treaty.

The identity of a foreign Shareholder may be disclosed on the Fund's U.S. tax return. In addition, foreign Shareholders may have to supply certain beneficial ownership statements to the Fund (which would be available to the Service) in order to obtain reductions in U.S. withholding tax on interest and to obtain benefits under U.S. income tax treaties, to the extent applicable.

ERISA CONSIDERATIONS

The following summary of certain aspects of ERISA is based upon ERISA, judicial decisions, U.S. Department of Labor ("DOL") regulations and rulings in existence on the date hereof. This summary is general in nature and does not address every ERISA issue that may be applicable to the Fund or a particular investor. Accordingly, each prospective investor should consult with its own counsel in order to understand the ERISA issues affecting the Fund and the investor.

General

Persons who are fiduciaries with respect to a U.S. employee benefit plan or trust within the meaning of and subject to the provisions of ERISA (an "ERISA Plan"), an individual retirement account or a Keogh plan subject solely to the provisions of the Code* (an "Individual Retirement Fund") should consider, among other things, the matters described below before determining whether to invest in the Fund.

ERISA imposes certain general and specific responsibilities on persons who are fiduciaries with respect to an ERISA Plan, including prudence, diversification, avoidance of prohibited transactions and compliance with other standards. In determining whether a particular investment is appropriate for an ERISA Plan, DOL regulations provide that a fiduciary of an ERISA Plan must give appropriate consideration to, among other things, the role that the investment plays in the ERISA Plan's portfolio, taking into consideration whether the investment is designed reasonably to further the ERISA Plan's purposes, the risk and return factors of the potential investment, the portfolio's composition with regard to diversification, the liquidity and current return of the total portfolio relative to the anticipated cash flow needs of the ERISA Plan, the projected return of the total portfolio relative to the ERISA Plan's funding objectives, and the limitation on the rights of Shareholders to redeem all or a portion of their Shares or to transfer their Shares. Before investing the assets of an ERISA Plan in the Fund, a fiduciary should determine whether such an investment is consistent with its fiduciary responsibilities and the foregoing regulations. For example, a fiduciary should consider whether an investment in the Fund may be too illiquid or too speculative for a particular ERISA Plan and whether the assets of the ERISA Plan would be sufficiently diversified. If a fiduciary with respect to any such ERISA Plan breaches its responsibilities with regard to selecting an investment or an investment course of action for such ERISA Plan, the fiduciary may be held personally liable for losses incurred by the ERISA Plan as a result of such breach.

Plan Assets Defined

ERISA and applicable DOL regulations describe when the underlying assets of an entity in which "benefit plan investors", as defined in Section 3(42) of ERISA and any regulations promulgated thereunder ("Benefit Plan Investors"), invest are treated as "plan assets" for purposes of ERISA. Under ERISA, the term Benefit Plan Investors is defined to include an "employee benefit plan" that is subject to the provisions of Title I of ERISA, a "plan" that is subject to the

* References hereinafter made to ERISA include parallel references to the Code.

prohibited transaction provisions of Section 4975 of the Code, and entities the assets of which are treated as "plan assets" by reason of investment therein by Benefit Plan Investors.

Under ERISA, as a general rule, when an ERISA Plan invests assets in another entity, the ERISA Plan's assets include its investment, but do not, solely by reason of such investment, include any of the underlying assets of the entity. However, when an ERISA Plan acquires an "equity interest" in an entity that is neither: (a) a "publicly offered security"; nor (b) a security issued by an investment fund registered under the Company Act, then the ERISA Plan's assets include both the equity interest and an undivided interest in each of the underlying assets of the entity, unless it is established that: (i) the entity is an "operating company"; or (ii) the equity participation in the entity by Benefit Plan Investors is limited.

Under ERISA, the assets of an entity will not be treated as "plan assets" if Benefit Plan Investors hold less than 25% (or such greater percentage as may be provided in regulations promulgated by the DOL) of the value of each class of equity interests in the entity. Equity interests held by a person with discretionary authority or control with respect to the assets of the entity and equity interests held by a person who provides investment advice for a fee (direct or indirect) with respect to such assets or any affiliate of any such person (other than a Benefit Plan Investor) are not considered for purposes of determining whether the assets of an entity will be treated as "plan assets" for purposes of ERISA. The Benefit Plan Investor percentage of ownership test applies at the time of an acquisition by any person of the equity interests. In addition, an advisory opinion of the DOL takes the position that a redemption of an equity interest by an investor constitutes the acquisition of an equity interest by the remaining investors (through an increase in their percentage ownership of the remaining equity interests), thus triggering an application of the Benefit Plan Investor percentage of ownership test at the time of the redemption.

Limitation on Investments by Benefit Plan Investors

It is the current intent of the Investment Manager to monitor the investments in the Fund to ensure that the aggregate investment by Benefit Plan Investors does not equal or exceed 25% (or such greater percentage as may be provided in regulations promulgated by the DOL) of the value of any class of equity interests in the Fund so that assets of the Fund will not be treated as "plan assets" under ERISA. Equity interests held by the Investment Manager or its affiliates are not considered for purposes of determining whether the assets of the Fund were treated as "plan assets" of a Benefit Plan Investor, the Investment Manager would be a "fiduciary" (as defined in ERISA and the Code) with respect to each such Benefit Plan Investor, and would be subject to the obligations and liabilities imposed on fiduciaries by ERISA. In such circumstances, the Fund would be subject to various other requirements of ERISA and the Code. In particular, the Fund would be subject to rules restricting transactions with "parties in interest" and prohibiting transactions involving conflicts of interest on the part of fiduciaries which might result in a violation of ERISA and the Code unless the Fund obtained appropriate exemptions from the DOL allowing the Fund to conduct its operations as described herein. As described above under "Redemptions - Required Redemptions", the Board of Directors may, in its sole discretion, compulsorily redeem all or any portion of a Shareholder's Shares, including, without limitation, to ensure compliance with the percentage limitation on investment in the Fund by Benefit Plan Investors as set forth above. The Investment Manager reserves the right, however, to waive the percentage limitation on investment in the Fund by Benefit Plan Investors and thereafter to comply with ERISA.

Representations by Plans

An ERISA Plan proposing to invest in the Fund will be required to represent that it is, and any fiduciaries responsible for the ERISA Plan's investments are, aware of and understand the Fund's investment objectives, policies and strategies, and that the decision to invest plan assets in the Fund was made with appropriate consideration of relevant investment factors with regard to the ERISA Plan and is consistent with the duties and responsibilities imposed upon fiduciaries with regard to their investment decisions under ERISA.

Whether or not the assets of the Fund are treated as "plan assets" for purposes of ERISA, an investment in the Fund by an ERISA Plan is subject to ERISA. Accordingly, fiduciaries of ERISA Plans should consult with their own counsel as to the consequences under ERISA of an investment in the Fund.

ERISA Plans and Individual Retirement Funds Having Prior Relationships with the Investment Manager or its Affiliates

Certain prospective ERISA Plan and Individual Retirement Fund investors may currently maintain relationships with the Investment Manager or other entities that are affiliated with the Investment Manager. Each of such entities may be deemed to be a party in interest to, and/or a fiduciary of, any ERISA Plan or Individual Retirement Fund to which any of the Investment Manager or its affiliates provides investment management, investment advisory or other services. ERISA prohibits ERISA Plan assets to be used for the benefit of a party in interest and also prohibits an ERISA Plan fiduciary from using its position to cause the ERISA Plan to make an investment from which it or certain third parties in which such fiduciary has an interest would receive a fee or other consideration. Similar provisions are imposed by the Code with respect to Individual Retirement Funds. ERISA Plan and Individual Retirement Fund investors should consult with counsel to determine if participation in the Fund is a transaction that is prohibited by ERISA or the Code.

Eligible Indirect Compensation

The disclosures set forth in this Memorandum constitute the Investment Manager's good faith efforts to comply with the disclosure requirements of Form 5500, Schedule C and allow for the treatment of its compensation as eligible indirect compensation.

Future Regulations and Rulings

The provisions of ERISA are subject to extensive and continuing administrative and judicial interpretation and review. The discussion of ERISA contained herein is, of necessity, general and may be affected by future publication of regulations and rulings. Potential investors should consult with their legal advisers regarding the consequences under ERISA of the acquisition and ownership of Shares.

REGULATORY MATTERS

Company Act Regulation

The Fund will comply with Section 3(c)(1) or 3(c)(7) of the Company Act.

Anti-Money Laundering Regulations

Identity Verification. In order to comply with laws and regulations aimed at the prevention of money laundering and terrorist financing, the Fund is required to adopt and maintain anti-money laundering procedures and, accordingly, the Fund, or the Administrator on the Fund's behalf, may require subscribers to provide evidence to verify their identity, the identity of their beneficial owners and controllers (where applicable), and the source of funds.

The Fund, and the Administrator on the Fund's behalf, may request such information as is necessary to verify the identity of any Shareholder (including any subscriber or a transferee) and the identity of their beneficial owners and controllers (where applicable). Where the circumstances permit, the Fund, or the Administrator on the Fund's behalf, may be satisfied that full due diligence may not be required at subscription where a relevant exemption applies under applicable law. However, detailed verification information may be required prior to the payment of any proceeds from or any transfer of an interest in Shares.

In the event of delay or failure by a subscriber or Shareholder to produce any information required for verification purposes, the Fund, or the Administrator on the Fund's behalf, may (i) refuse to accept or delay the acceptance of a subscription; (ii) in the case of a transfer of Shares, refuse to register the relevant transfer of Shares; (iii) in the case of a subscription for Shares, refuse to allot the Shares subscribed for, in which event subscription moneys will be returned without interest to the account from which such moneys were originally debited; or (iv) cause the redemption of any such Shareholder from the Fund.

The Fund, and the Administrator on the Fund's behalf, also may refuse to make any redemption or dividend payment to a Shareholder if the Directors or the Administrator suspect or are advised that the payment of redemption or dividend proceeds to such Shareholder may be non-compliant with applicable laws or regulations, or if such refusal is considered necessary or appropriate to ensure the compliance by the Fund or the Administrator with any applicable laws or regulations.

The Monetary Authority has a discretionary power to impose substantial administrative fines upon the Fund in connection with any breaches by the Fund of prescribed provisions of the Anti-Money Laundering Regulations (Revised) of the Cayman Islands, as amended and revised from time to time (the "**AML Regulations**"), and upon any Director or officer of the Fund who either consented to or connived in the breach, or to whose neglect the breach is proved to be attributable. To the extent any such administrative fine is payable by the Fund, the Fund will bear the costs of such fine and any associated proceedings.

Freezing Accounts. Each of the Fund and the Administrator reserves the right, and the Fund may be obligated, pursuant to any applicable anti-money laundering laws or the laws, regulations, and Executive Orders administered by the U.S. Department of Treasury's Office of

Foreign Assets Control ("**OFAC**"), or other laws or regulations in any relevant jurisdiction (collectively, "**AML/OFAC Obligations**"), to "freeze the account" of a subscriber or Shareholder, either by (i) rejecting the subscription of a subscriber or Shareholder; (ii) segregating the assets in the account in compliance with applicable laws or regulations (including by way of compulsory redemption and automatic application of the proceeds of such compulsory redemption to a subscription for Shares of separate classes, tranches and/or series); (iii) declining any redemption request of a Shareholder; (iv) suspending payment of redemption proceeds to a Shareholder; and/or (v) refusing to make any dividend payment to a Shareholder. The Fund may be required to report such action and to disclose the subscriber's or Shareholder's identity to OFAC or other applicable governmental and regulatory authorities.

Sanctions and Required Representations. The Fund is subject to laws that restrict it from dealing with certain persons, including persons that are located or domiciled in sanctioned jurisdictions. Accordingly, each subscriber and Shareholder (including any transferee) will be required to make such representations to the Fund as the Fund, the Investment Manager or the Administrator will require in connection with applicable AML/OFAC Obligations, including representations to the Fund that, to the best of its knowledge, such subscriber or Shareholder (and (i) any person controlling or controlled by the subscriber or Shareholder; (ii) if the subscriber or Shareholder is a privately held entity, any person having a beneficial interest in the subscriber or Shareholder; (iii) if required under Cayman Islands law, such persons having a beneficial interest in the subscriber or Shareholder as determined under Cayman Islands law; (iv) any person for whom the subscriber or Shareholder is acting as agent or nominee in connection with the investment; and (v) any authorized persons in respect of such subscriber or Shareholder) is not (a) a country, territory, individual or entity named on an OFAC list, any list maintained under the European Union ("**EU**") or United Kingdom ("**UK**") Regulations (as extended to the Cayman Islands by statutory instrument) or any similar list maintained under applicable law ("**Sanctions Lists**"); (b) dealing with any third-party named on any Sanctions List; (c) operationally based or domiciled in a country or territory in relation to which current sanctions have been issued by the United Nations, EU or UK; or (d) a person or entity prohibited under the programs administered by OFAC or any other similar economic and trade sanctions program. Where a Shareholder is named on any of the Sanctions Lists, the Fund may be required to cease any further dealings with the Shareholder's interest in the Fund until such sanctions are lifted or a license is sought under applicable law to continue dealings.

Each subscriber and Shareholder (including any transferee) will also be expected to represent to the Fund that, to the best of its knowledge, such subscriber or Shareholder (and (i) any person controlling or controlled by the subscriber or Shareholder; (ii) if the subscriber or Shareholder is a privately held entity, any person having a beneficial interest in the subscriber or Shareholder; (iii) if required under Cayman Islands law, such persons having a beneficial interest in the subscriber or Shareholder as determined under Cayman Islands law; (iv) any person for whom the subscriber or Shareholder is acting as agent or nominee in connection with the investment; and (v) any authorized persons in respect of such subscriber or Shareholder) is not a politically exposed person,[*] or any family member[**] or close associate[***] of a politically exposed person. Any subscriber or Shareholder (including any transferee) that cannot make such representations may be subject to enhanced due diligence and the Fund may decline to accept any subscription or process any transfer in such circumstances.

Each subscriber and Shareholder (including any transferee) will also be required to represent to the Fund that, to the best of its knowledge, such subscriber or Shareholder (and (i) any person controlling or controlled by the subscriber or Shareholder; (ii) if the subscriber or Shareholder is a privately held entity, any person having a beneficial interest in the subscriber or Shareholder; (iii) if required under Cayman Islands law, such persons having a beneficial interest in the subscriber or Shareholder as determined under Cayman Islands law; (iv) any person for whom the subscriber or Shareholder is acting as agent or nominee in connection with the investment; and (v) any authorized persons in respect of such subscriber or Shareholder) is not a shell bank[****]. Further, if such subscriber or Shareholder is a non-U.S. banking institution (a "**Non-U.S. Bank**") or if such subscriber or Shareholder receives deposits from, makes payments on behalf of, or handles other financial transactions related to a Non-U.S. Bank, such subscriber or Shareholder must represent to the Fund that: (i) the Non-U.S. Bank has a fixed address, other than solely an electronic address, in a country in which the Non-U.S. Bank is authorized to conduct banking activities; (ii) the Non-U.S. Bank employs one or more individuals on a full-time basis; (iii) the Non-U.S. Bank maintains operating records related to its banking activities; (iv) the Non-U.S. Bank is subject to inspection by the banking authority that licensed the Non-U.S. Bank to conduct banking activities; and (v) the Non-U.S. Bank does not provide banking services to any other Non-U.S. Bank that does not have a physical presence in any country and that is not a regulated affiliate.

Such subscriber or Shareholder will also be required to represent to the Fund that amounts contributed by it to the Fund were not directly or indirectly derived from activities that may contravene applicable laws and regulations, including, without limitation, any applicable anti-money laundering laws and regulations.

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[*] For these purposes, the term "**politically exposed person**" means (a) a person who is or has been entrusted with prominent public functions by a foreign (non-Cayman Islands) country, for example a Head of State or of government, senior politician, senior government, judicial or military official, senior executive of a state-owned corporation, and important political party official; (b) a person who is or has been entrusted domestically (in the Cayman Islands) with prominent public functions, for example a Head of State or of government, senior politician, senior government, judicial or military official, senior executives of a state-owned corporation and important political party official; and (c) a person who is or has been entrusted with a prominent function by an international organization like a member of senior management, such as a director, a deputy director and a member of the board or equivalent functions.

[**] For these purposes, the term "**family member**" includes the spouse, parent, sibling or child of a politically exposed person.

[***] For these purposes, the term "**close associate**" means any natural person who is known to hold the ownership or control of a legal instrument or person jointly with a politically exposed person, or who maintains some other kind of close business or personal relationship with a politically exposed person, or who holds the ownership or control of a legal instrument or person which is known to have been established to the benefit of a politically exposed person.

[****] For these purposes, the term "**shell bank**" means any institution that accepts currency for deposit and that (a) has no physical presence in the jurisdiction in which it is incorporated or in which it is operating, as the case may be, and (b) is unaffiliated with a regulated financial group that is subject to consolidated supervision.

Each subscriber and Shareholder must notify the Fund promptly in writing should it become aware of any change in the information set forth in its representations.

Required Reporting. If any person in the Cayman Islands knows or suspects or has reasonable grounds for knowing or suspecting that another person is engaged in criminal conduct or money laundering or is involved with terrorism or terrorist financing and property and the information for that knowledge or suspicion came to their attention in the course of business in the regulated sector, or other trade, profession, business or employment, the person will be required to report such knowledge or suspicion to (i) the Financial Reporting Authority of the Cayman Islands, pursuant to the Proceeds of Crime Act (Revised) of the Cayman Islands, if the disclosure relates to criminal conduct or money laundering, or (ii) a police officer of the rank of constable or higher, or the Financial Reporting Authority, pursuant to the Terrorism Act (Revised) of the Cayman Islands, if the disclosure relates to involvement with terrorism or terrorist financing and property. Such a report will not be treated as a breach of confidence or of any restriction upon the disclosure of information imposed by any enactment or otherwise.

Pursuant to the AML Regulations, the Fund must designate natural persons to act as Anti-Money Laundering Compliance Officer, Money Laundering Reporting Officer and Deputy Money Laundering Reporting Officer (collectively, the "**AML Officers**") of the Fund. Subscribers and Shareholders may obtain details (including contact details) of the current AML Officers of the Fund by contacting Investor Relations at IR@panteracapital.com or (650) 854-7000.

Delegation. Where permitted by applicable law, and subject to certain conditions, the Fund may delegate the maintenance of its anti-money laundering procedures (including the acquisition of due diligence information) to a suitable person.

Cayman Islands Mutual Funds Act

The Fund is regulated as a mutual fund under the Mutual Funds Act under Section 4(3) of the Mutual Funds Act of the Cayman Islands and, accordingly, is regulated pursuant to that law. However, the Fund is not required to be licensed or to employ a licensed mutual fund administrator since the minimum aggregate equity interest purchasable by a prospective investor in the Fund is at least $50,000 or its equivalent in any other currency. The Monetary Authority has supervisory and enforcement powers to ensure compliance with the Mutual Funds Act. Regulation under the Mutual Funds Act entails the filing of prescribed details and audited accounts annually with the Monetary Authority. The Monetary Authority may at any time instruct the Fund to have its accounts audited and to submit them to the Monetary Authority within such time as the Monetary Authority specifies. Failure to comply with these requests by the Monetary Authority may result in substantial fines on the part of the Board of Directors and may result in the Monetary Authority applying to the court to have the Fund wound up.

The Fund will not, however, be subject to supervision in respect of its investment activities or the constitution of the Fund's portfolio by the Monetary Authority or any other governmental authority in the Cayman Islands, although the Monetary Authority does have the power to investigate the activities of the Fund in certain circumstances. Neither the Monetary Authority nor any other governmental authority in the Cayman Islands has passed judgment upon or approved the terms or merits of this Memorandum. There is no investment compensation scheme available to investors in the Cayman Islands.

The Monetary Authority may take certain actions if it is satisfied that a regulated mutual fund is or is likely to become unable to meet its obligations as they fall due; has contravened any provision under the Mutual Funds Act or of the Anti-Money Laundering Regulations (Revised); is carrying on or is attempting to carry on business or is winding up its business voluntarily in a manner that is prejudicial to its investors or creditors; is not being managed in a fit and proper manner; or has a person appointed as director, manager or officer that is not a fit and proper person to hold the respective position. The powers of the Monetary Authority include the power to require the substitution of Directors and/or the Investment Manager, to appoint a person to advise the Fund on the proper conduct of its affairs or to appoint a person to assume control of the affairs of the Fund. There are other remedies available to the Monetary Authority including the ability to apply to court for approval of other actions.

The Monetary Authority has a discretionary power to impose substantial administrative fines upon the Fund in connection with any breaches by the Fund of prescribed provisions of certain regulatory laws and regulations of the Cayman Islands including the Mutual Funds Act and the Anti-Money Laundering Regulations (Revised) of the Cayman Islands and upon any director or officer of the Fund who either consented to or connived in the breach, or to whose neglect the breach is proved to be attributable. To the extent any such administrative fine is payable by the Fund, the Fund will bear the costs of such fine and any associated proceedings.

The Fund and any of its or their directors or agents domiciled in the Cayman Islands, may be compelled to provide information, subject to a request for information made by a regulatory or governmental authority or agency under applicable law; *e.g.*, by the Monetary Authority, either for itself or for a recognized overseas regulatory authority, under the Monetary Authority Act (as amended), or by the Tax Information Authority, under the Tax Information Authority Act (as amended) or Reporting of Savings Income Information (European Union) Act (as amended) and associated regulations, agreements, arrangements and memoranda of understanding. Disclosure of confidential information under such laws will not be regarded as a breach of any duty of confidentiality and, in certain circumstances, the Fund and any of its or their directors or agents, may be prohibited from disclosing that the request has been made.

Cayman Islands Data Protection Act

The Cayman Islands Government enacted the Data Protection Act, 2017 (the "DPL") on May 18, 2017. The DPL introduces legal requirements for the Fund based on internationally accepted principles of data privacy.

The Fund will be characterized as a data controller in respect of personal data. The Fund's affiliates and/or delegates, such as the Administrator and the Investment Manager, may act as data processors (or data controllers in their own right in some circumstances). The Administrator, as data processor, may process personal data in order to provide services under the Administration Agreement and to carry out anti-money laundering checks and related actions; disclose or transfer the personal data to its affiliates, employees, agents, delegates, subcontractors, credit reference agencies, professional advisors or competent authorities for the provision of the services; and report tax or regulatory related information to competent bodies or authorities. The Administrator, as data processor, shall, among other things, only act on and process such personal data in accordance with the documented instructions of the Fund, unless otherwise prevented or required by applicable laws; ensure that all persons who have access to personal data have committed themselves to appropriate obligations of confidentiality; and, upon termination of the Administration Agreement, the personal data shall, at the Fund's option, be destroyed or returned to the Fund, unless applicable laws prevent the return or deletion of such personal data.

Oversight of the DPL is the responsibility of the Ombudsman's office of the Cayman Islands. Breach of the DPL by the Fund could lead to enforcement action by the Ombudsman, including the imposition of remediation orders, monetary penalties or referral for criminal prosecution.

Cayman Islands Companies Act

The Fund was incorporated as an exempted company with limited liability under the Companies Act (Revised) of the Cayman Islands (the "Companies Act"). A Cayman Islands exempted company:

(a) is a company that conducts its business mainly outside the Cayman Islands;
(b) is prohibited from trading in the Cayman Islands with any person, firm or corporation except in furtherance of the business of the exempted company carried on outside the Cayman Islands (and for this purpose can effect and conclude contracts in the Cayman Islands and exercise in the Cayman Islands all of its powers necessary for the carrying on of its business outside the Cayman Islands);
(c) does not have to hold an annual general meeting;
(d) does not have to make its register of members open to inspection by shareholders of that company;
(e) may register by way of continuation in another jurisdiction and be deregistered in the Cayman Islands; and
(f) may register as a segregated portfolio company.

Inspection of Books and Records

Holders of Shares have no general right under the Companies Act to inspect or obtain copies of the Fund's register of members or the Fund's corporate records.

General Meetings

As a Cayman Islands exempted company, the Fund is not obligated by the Companies Act to call shareholders' annual general meetings.

Register of Members

Under the Companies Act, the Fund must keep a register of members and there should be entered therein the names and addresses of the Fund's Shareholders, a statement of the

Shares held by each Shareholder, and of the amount paid or agreed to be considered as paid, on the Shares of each Shareholder; the date on which the name of any person was entered on the register as a Shareholder; and the date on which any person ceased to be a Shareholder. Under the Companies Act, the register of members of the Fund is prima facie evidence of the matters set out therein (that is, the register of members will raise a presumption of fact on the matters referred to above unless rebutted) and a Shareholder registered in the register of members is deemed as a matter of the Companies Act to have legal title to the Shares as set against its name in the register of members.

Dissolution; Winding Up

Under the Companies Act and the Articles, the Fund may be wound up by a special resolution of the Fund's voting shareholders, or if the winding up is initiated by the Fund's board of directors, by either a special resolution of the Fund's voting shareholders or, if the Fund is unable to pay its debts as they fall due, by an ordinary resolution of the Fund's voting shareholders. In addition, a company may be wound up by an order of the courts of the Cayman Islands. The court has authority to order winding up in a number of specified circumstances including where it is, in the opinion of the court, just and equitable to do so.

General Information

The address of the directors of the Fund shall be at the registered office of the Fund.

The base currency of the Fund is U.S. dollars.

No certificates will be issued as evidence of ownership of the Shares. The register of members maintained by the Administrator shall be *prima facie* evidence of ownership of the Shares and the matters which are directed by the Companies Act to be inserted therein.

Information as to the issue and redemption prices may be obtained from the Administrator.

Copies of the Articles and any annual or periodic reports may be inspected and obtained at the offices of the Investment Manager.

The Fund has retained Cohen & Company (Cayman) as its independent auditor. The auditor receives from the Fund customary fees for its services.

CAPITAL STRUCTURE OF THE FUND

Authorized Capital and Division of Shares

The Fund has authorized capital of $50,000 divided into 4,999,999 non-voting, redeemable, participating shares, $0.01 par value each, which may be allocated by the Board of Directors, in its discretion, among various Tranches of Shares, and one voting share, $0.01 par value, which is held by the Advisor (the "Management Share"). No capital of the Fund is under option or agreed, conditionally or unconditionally, to be put under option to any person.

The Fund may, from time to time, by an ordinary resolution, increase the Fund's authorized share capital, consolidate and divide all or any of the Shares into a smaller number of Shares, sub-divide the Shares into a larger number of shares, or cancel any Shares not taken or agreed to be taken by any person. The Fund may, from time to time, by a special resolution, reduce its share capital in any way permitted by the laws of the Cayman Islands.

Shares will be registered in the name of the Shareholder and held in book-entry form unless otherwise requested in writing by a Shareholder.

Except as specifically described in this Memorandum, the Shares have no conversion or pre-emptive rights. All Shares, when duly issued, will be fully paid and non-assessable.

Participation and Voting

Shareholders that participate in the profits of the Fund do so in proportion to the net asset value per Share of the various Tranches of Shares they hold. In the event of the liquidation or dissolution of the Fund, the net assets of the Fund remaining after the satisfaction of the rights of creditors and payment of the par value of the Management Share and the Shares will also be distributed to the Shareholders in proportion to the net asset value per Share of the various Tranches of Shares.

The Management Share confers upon the holder thereof the right to receive notice of, to attend and to vote at general meeting of the Fund. The Management Share is held by the Advisor, but may be subsequently transferred by the Advisor to a different person or entity.

The Participating Shares are non-voting and do not confer upon the holder thereof the right to receive notice of, to attend or to vote at general meetings of the Fund.

Rights of Shareholders

All Shareholders are entitled to the benefit of, are bound by and are deemed to have notice of the provisions of, the Articles of Association. Under the terms of the Articles of Association, the liability of the Shareholders is limited to any amount unpaid on their Shares. As the Shares can only be issued if they are fully paid, the Shareholders will not be liable for any debt, obligation or default of the Fund beyond their interest in the Fund.

The Articles of Association have been drafted in broad and flexible terms to allow the Directors the authority, in their discretion, to determine a number of issues, including, without limitation, whether or not to charge subscription fees, generally or in any particular case. In approving the offering of Shares on the terms set out in this Memorandum, the Directors have exercised a number of these discretions in accordance with the Articles of Association.

Variation of Share Rights

The Articles of Association provide that, subject to the Companies Act (as amended) of the Cayman Islands (the "Companies Act") and the other provisions of the Articles of Association, all or any of the Tranche rights or other terms of offer, whether set out in this Memorandum, any Subscription Agreement or otherwise (including any representations, warranties, covenants or disclosure relating to the offer or holding of Shares) (collectively referred to as "Share Rights") for the time being applicable to any Tranche of Shares in issue (unless otherwise provided by the terms of issue of those Shares) may (whether or not the Fund is being wound up) be varied without the consent of the holders of the issued Shares of that Tranche where such variation is considered by the Directors, not to have a material adverse effect upon such holders' Share Rights; otherwise, any such variation will be made only with the prior consent in writing of the holders of not less than two-thirds by net asset value of such Shares, or with the sanction of a resolution passed by a majority of at least two-thirds of the votes cast in person or by proxy at a separate meeting of the holders of such Shares. For the avoidance of doubt, the Directors reserve the right, notwithstanding that any such variation may not have a material adverse effect, to obtain consent from the holders of such Shares. Each subscriber for Shares will be required to acknowledge and agree that the terms of this offering of Shares and the rights attaching to the Shares, as set forth in this Memorandum and in the applicable Subscription Agreement, can be varied in accordance with the provisions of the Articles of Association.

Negative Consent

The Articles of Association provide that, where consent is required with respect to any Tranche, pursuant to the "Variation of Share Rights" Article, the Directors in their discretion may invoke the following procedure (the "Negative Consent Procedure"). The Directors will provide written notice in respect of the proposed variation (the "Proposal") to the Shareholders of the affected Tranche and will specify a deadline (the "Redemption Deadline"), which will be no earlier than 15 days after the date of giving such notice, by which date such members may submit a written request for redemption of some or all of their Shares of the affected Tranche no later than the Redemption Deadline. The terms of the Proposal will be such that its specified effective date (the "Effective Date") will not be on or prior to the Redemption Deadline. In the event that such redemptions are delayed due to the Redemption Queue, such Proposal shall not be effected until redemptions submitted prior to the Redemption Deadline have been satisfied in full. Such notice will further provide that the holders of any Shares in respect of which a request for redemption has not been received by the Redemption Deadline (the "Affected Shares") will, in the absence of express written refusal to consent, be deemed to have consented in writing to the Proposal (such Affected Shares being the "Negative Consent Shares"). In the event that the Negative Consent Procedure is followed, only the Affected Shares will be considered for the purposes of determining whether the written consent majority has been obtained under the "Variation of Share Rights" Article with the holders of the Negative Consent Shares being deemed to have submitted a written consent in favor of the Proposal on the Effective Date.

Dividends

Dividends may be paid in the sole discretion of the Board of Directors. To the extent that a dividend may be declared, it will be paid in compliance with any applicable laws. It is not anticipated that the Fund will pay dividends.

LEGAL COUNSEL

SRZ has been engaged by the Investment Manager to represent it as U.S. legal counsel in connection with the organization of the Fund and this offering of Shares. SRZ also has been engaged by the Board of Directors to represent the Fund in connection with these matters and other matters for which it is retained to do so. Ogier ("Ogier", and together with SRZ, "Legal Counsel") has been engaged to act as Cayman Islands legal counsel by the Board of Directors to represent the Fund in connection with the organization of the Fund and this offering of Shares in the Fund. No separate counsel has been engaged to independently represent the Shareholders in connection with these matters.

Each Legal Counsel will represent the Fund on matters for which it is retained to do so. Other counsel may also be retained where the Investment Manager, on its own behalf, or the Board of Directors determines that to be appropriate.

Each Legal Counsel's representation of the Fund is limited to specific matters as to which they have been consulted by the Fund. There may exist other matters that could have a bearing on the Fund as to which a Legal Counsel has not been consulted. In connection with the preparation of this Memorandum, SRZ is responsible only for matters of United States law and does not accept responsibility in relation to any other matters referred to or disclosed in this Memorandum, and Ogier is responsible only for matters of Cayman Islands law and does not accept responsibility in relation to any other matters referred to or disclosed in this Memorandum. In advising the Fund and the Investment Manager with respect to the preparation of this Memorandum, each Legal Counsel has relied upon information that has been furnished to it by the Fund, the Investment Manager and their affiliates, and has not independently investigated or verified the accuracy or completeness of the information set forth herein. In addition, Legal Counsel does not monitor the compliance of the Fund or the Investment Manager with the investment guidelines, valuation procedures and other guidelines set forth in this Memorandum or the Fund's terms or compliance with applicable laws.

There may be situations in which there is a "conflict" between the interests of the Investment Manager and those of the Fund. In these situations, such parties will determine the appropriate resolution thereof, and may seek advice from Legal Counsel in connection with such determinations. The Investment Manager (with respect to SRZ) and the Fund have each consented to Legal Counsel's concurrent representation of such parties in such circumstances. In general, independent counsel will not be retained to represent the interests of the Fund or the Shareholders.

Legal Counsel received fees calculated on a combination of a fixed fee and time spent basis in connection with the formation and launch of the Fund and may continue to receive fees on such basis in connection with ongoing legal and regulatory advice.

SUITABILITY REQUIREMENTS

Shareholders must meet the suitability requirements set forth in the section of this Memorandum entitled, "Summary of Terms—Suitability Requirements".

Each prospective Shareholder generally must be either a non-U.S. Person or a U.S. Person and must meet other suitability requirements described herein and in the Subscription Agreement.

The term "U.S. Person" means a person described in one or more of the following paragraphs:

1. With respect to any person, any individual or entity that would be a U.S. Person under Regulation S promulgated under the Securities Act. The Regulation S definition is set forth in Appendix A to this Memorandum.

2. With respect to individuals, any U.S. citizen or "resident alien" within the meaning of U.S. income tax laws as in effect from time to time. Currently, the term "resident alien" is defined under U.S. income tax laws to generally include any individual who (i) holds an Alien Registration Card (a "green card") issued by the U.S. Immigration and Naturalization Service or (ii) meets a "substantial presence" test. The "substantial presence" test is generally met with respect to any current calendar year if (a) the individual was present in the U.S. on at least 31 days during such year and (b) the sum of the number of days on which such individual was present in the U.S. during the current year, $^1/_3$ of the number of such days during the first preceding year, and $^1/_6$ of the number of such days during the second preceding year, equals or exceeds 183 days.

3. With respect to persons other than individuals:

   (i) a corporation or partnership created or organized in the United States or under the laws of the United States or any state;

   (ii) a trust where (a) a U.S. court is able to exercise primary supervision over the administration of the trust and (b) one or more U.S. Persons have the authority to control all substantial decisions of the trust; and

   (iii) an estate which is subject to U.S. tax on its worldwide income from all sources.

Each prospective purchaser is urged to consult with its own advisers to determine the suitability of an investment in the Shares, and the relationship of such an investment to the purchaser's overall investment program and financial and tax position. Each purchaser of Shares is required to represent that it has evaluated the risks of investing in the Fund, understands there are substantial risks of loss incidental to the purchase of Shares and has determined that the Shares are a suitable investment for such purchaser.

APPENDIX A

REGULATION S DEFINITION OF U.S. PERSON

Pursuant to Rule 902(k) of Regulation S under the Securities Act:

(1) "U.S. person" means:

(i) any natural person resident in the United States;

(ii) any partnership or corporation organized or incorporated under the laws of the United States;

(iii) any estate of which any executor or administrator is a U.S. person;

(iv) any trust of which any trustee is a U.S. person;

(v) any agency or branch of a foreign entity located in the United States;

(vi) any non-discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary for the benefit or account of a U.S. person;

(vii) any discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary organized, incorporated, or (if an individual) resident in the United States; and

(viii) any partnership or corporation if:

(A) organized or incorporated under the laws of any foreign jurisdiction; and

(B) formed by a U.S. person principally for the purpose of investing in securities not registered under the Securities Act, unless it is organized or incorporated, and owned, by accredited investors (as defined in Rule 501(a) under the Securities Act) who are not natural persons, estates or trusts.

(2) The following are not "U.S. persons":

(i) any discretionary account or similar account (other than an estate or trust) held for the benefit or account of a non-U.S. person by a dealer or other professional fiduciary organized, incorporated, or (if an individual) resident in the United States;

(ii) any estate of which any professional fiduciary acting as executor or administrator is a U.S. person if:

(A) an executor or administrator of the estate who is not a U.S. person has sole or shared investment discretion with respect to the assets of the estate; and

(B) the estate is governed by foreign law;

(iii) any trust of which any professional fiduciary acting as trustee is a U.S. person, if a trustee who is not a U.S. person has sole or shared investment discretion with respect to the trust assets, and no beneficiary of the trust (and no settlor if the trust is revocable) is a U.S. person;

(iv) an employee benefit plan established and administered in accordance with the law of a country other than the United States and customary practices and documentation of such country;

(v) any agency or branch of a U.S. person located outside the United States if:

(A) the agency or branch operates for valid business reasons; and

(B) the agency or branch is engaged in the business of insurance or banking and is subject to substantive insurance or banking regulation, respectively, in the jurisdiction where located; and

(vi) The International Monetary Fund, the International Bank for Reconstruction and Development, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the United Nations, and their agencies, affiliates and pension plans, and any other similar international organizations, their agencies, affiliates and pension plans.

APPENDIX B

OFFERING AND SALE RESTRICTIONS WITH RESPECT TO CERTAIN JURISDICTIONS

NOTE REGARDING MARKETING UNDER THE AIFM DIRECTIVE

In the United Kingdom and each member state (each a "relevant member state") of the EEA that has implemented the AIFM Directive, the Shares may only be offered to professional investors in accordance with the local measures implementing the AIFM Directive (such as where this Memorandum or any supplement provides that the Fund has been registered for the purposes of the national private placement regime of the relevant member state), or in any other circumstances permitted by local law of the United Kingdom or the relevant member state, including at the own initiative of the professional investor.

In relation to offers in the United Kingdom or the EEA, the Shares are not intended to be offered, or otherwise made available, to any person categorized as (i) a "retail client" (as defined in point (11) of Article 4(1) of MiFID II); or (ii) a "customer" (within the meaning of Directive 2002/92/EC on Insurance Mediation), where such customer does not qualify as a "professional client" (as defined in point (10) of Article 4(1) of MiFID II).

FOR PROSPECTIVE SHAREHOLDERS IN ARGENTINA

No public offering of Shares is being made to investors resident in Argentina. Shares are being offered only to a limited number of institutional investors and sophisticated individual investors capable of understanding the risks of their investment. The National Securities Commission of Argentina has not passed upon the accuracy or adequacy of this Memorandum or otherwise approved or authorized the offering of Shares to investors resident in Argentina.

FOR PROSPECTIVE SHAREHOLDERS IN AUSTRALIA

The Fund is not, and is not required to be, a registered foreign body corporate in Australia, and this Memorandum is not a prospectus lodged or required to be lodged with the Australian Securities and Investments Commission. The Shares will only be offered in Australia to persons to whom such securities may be offered without a prospectus under Chapter 6D of the Corporations Act 2001 (Cth). The Shares subscribed for by investors in Australia must not be offered for resale in Australia for 12 months from allotment except in circumstances where disclosure to investors under the Corporations Act 2001 (Cth) would not be required or where a compliant prospectus is produced. Prospective investors in Australia should confer with their professional advisers if in any doubt about their position.

FOR PROSPECTIVE SHAREHOLDERS IN THE BAHAMAS

The Fund has not been licensed or registered with the Securities Commission of The Bahamas because it is a non-Bahamas based investment fund for the purposes of the Investment Funds Act, 2019 (the "Bahamas IFA") and it is exempt from licensing under the Bahamas IFA. This Memorandum has not been registered with, reviewed or approved by the Securities Commission of The Bahamas. Shares may be offered in The Bahamas only if a copy of this Memorandum has been filed with the Securities Commission of The Bahamas, as required by the Bahamas IFA. Shares may only be offered in The Bahamas to "accredited investors", in compliance with Bahamian Exchange Control Regulations, by or through an investment fund administrator of the Fund that is licensed by, or a firm registered with, the Securities Commission of The Bahamas to sell securities.

FOR PROSPECTIVE SHAREHOLDERS IN THE KINGDOM OF BAHRAIN

Neither this Memorandum nor the Shares have been authorized by or registered or filed with the Central Bank of Bahrain or any other governmental authority in the Kingdom of Bahrain, nor has the Fund received authorization from the Central Bank of Bahrain or any other governmental authority in the Kingdom of Bahrain to market or sell the Shares within the Kingdom of Bahrain. This Memorandum does not constitute and may not be used for the purpose of an offer or invitation in the Kingdom of Bahrain. No services relating to the Shares, including the receipt of applications and the allotment or redemption of such Shares, may be rendered by the Fund within the Kingdom of Bahrain.

FOR PROSPECTIVE SHAREHOLDERS IN BERMUDA

Shares may be offered or sold in Bermuda only in compliance with the provisions of the Investment Business Act of 2003 of Bermuda which regulates the sale of securities in Bermuda. Additionally, non-Bermudian persons (including companies) may not carry on or engage in any trade or business in Bermuda unless such persons are permitted to do so under applicable Bermuda legislation.

FOR PROSPECTIVE SHAREHOLDERS IN BRAZIL

The Fund is not listed with any stock exchange, organized over the counter market or electronic system of securities trading. The Shares have not been and will not be registered with any securities exchange commission or other similar authority, including the Brazilian Securities and Exchange Commission (*Comissão de Valores Mobiliários* or the "CVM"). The Shares will not be directly or indirectly offered or sold within Brazil through any public offering, as determined by Brazilian law and by the rules issued by the CVM, including Law No. 6,385 (Dec. 7, 1976) and CVM Rule No. 400 (Dec. 29, 2003), as amended from time to time, or any other law or rules that may replace them in the future.

Acts involving a public offering in Brazil, as defined under Brazilian laws and regulations and by the rules issued by the CVM, including Law No. 6,385 (Dec. 7, 1976) and CVM Rule No. 400 (Dec. 29, 2003), as amended from time to time, or any other law or rules that may replace them in the future, must not be performed without such prior registration. Persons in Brazil wishing to acquire the Shares should consult with their own counsel as to the applicability of these registration requirements or any exemption therefrom. Without prejudice to the above, the sale and solicitation of the Shares is limited to professional investors as defined by CVM Rule No. 539 (Nov. 13, 2013), as amended, or as defined by any other rule that may replace it in the future.

This Memorandum is confidential and intended solely for the use of the addressee and cannot be delivered or disclosed in any manner whatsoever to any person or entity other than the addressee.

FOR PROSPECTIVE SHAREHOLDERS IN THE BRITISH VIRGIN ISLANDS

This Memorandum does not constitute, and there will not be, an offering of securities to the public in the British Virgin Islands.

FOR PROSPECTIVE SHAREHOLDERS IN BRUNEI

This Memorandum has not been delivered to, licensed or permitted by the Autoriti Monetari Brunei Darussalam as designated under the Securities Markets Order of 2013.

FOR PROSPECTIVE SHAREHOLDERS IN THE CAYMAN ISLANDS

This Memorandum does not constitute an offering, and there will not be any offering, of the Shares to the public in the Cayman Islands. No offer or invitation to subscribe for Shares may be made to the public in the Cayman Islands unless and until the Shares are listed on the Cayman Islands Stock Exchange.

FOR PROSPECTIVE SHAREHOLDERS IN CHILE

English Version

This offer conforms to General Ruling N°336 of the Chilean Commission for Financial Markets. The offer deals with securities not registered in the Registry of Securities or in the Registry of Foreign Securities of the Chilean Commission for Financial Markets, and therefore such securities are not subject to its oversight. The Fund is not obligated to provide public information in Chile regarding the Shares, since such securities are not registered with the Chilean Commission for Financial Markets. The Shares shall not be subject to public offering as long as they are not registered with the corresponding Registry of Securities in Chile.

Spanish Version

Esta oferta se acoge a la norma de Carácter General N° 336 de la Comisión para el Mercado Financiero Chilena. Que la oferta versa sobre valores no inscritos en el Registro de Valores o en el Registro de Valores Extranjeros que lleva la Comisión para el Mercado Financiero Chilena, por lo que tales valores no están sujetos a la fiscalización de ésta. Que por tratar de valores no inscritos no existe la obligación por parte del emisor de entregar en Chile información pública respecto de esos valores. Que esos valores no podrán ser objeto de oferta pública mientras no sean inscritos en el Registro de Valores correspondiente.

FOR PROSPECTIVE SHAREHOLDERS IN CHINA

The Shares may not be marketed, offered or sold directly or indirectly to the public in China and neither this Memorandum, which has not been submitted to the Chinese Securities and Regulatory Commission, nor any offering material or information contained herein relating to the Shares, may be supplied to the public in China or used in connection with any offer for the subscription or sale of the Shares to the public in China. The Shares may only be marketed, offered or sold to Chinese institutions which are authorized to engage in foreign exchange business and offshore investment from outside China. Chinese investors may be subject to foreign exchange control approval and filing requirements under the relevant Chinese foreign exchange regulations, as well as offshore investment approval requirements.

FOR PROSPECTIVE SHAREHOLDERS IN COLOMBIA

Neither this Memorandum nor the Shares have been reviewed or approved by the Financial Superintendency of Colombia or any other governmental authority in Colombia, nor has the Fund or any related person or entity received authorization or licensing from the Financial Superintendency of Colombia or any other governmental authority in Colombia to market or sell the Shares within Colombia. No public offering of the Shares is being made in Colombia or to Colombian residents. By receiving this Memorandum, the recipient acknowledges that it contacted the Investment Manager at its own initiative and not as a result of any promotion or publicity by the Investment Manager. This Memorandum is strictly private and confidential and may not be reproduced, used for any other purpose or provided to any person other than the intended recipient.

FOR PROSPECTIVE SHAREHOLDERS IN COSTA RICA

This offer is a private placement executed outside the Costa Rican territory, and must be ruled by the laws and jurisdiction of the Cayman Islands. The investor accepts that the security offered has no negotiation market and may not be offered through any media or any other way of publicity that could be interpreted by the Costa Rican governmental authorities as a public offer.

FOR PROSPECTIVE SHAREHOLDERS IN ECUADOR

The Fund is not managed or represented by a fund management company or trust administrator in Ecuador and has not been registered with or approved by the National Securities Council or the Superintendency of Companies, Securities and Insurance of Ecuador. Shares are therefore not eligible for advertising, placement or circulation in Ecuador. The information provided in this Memorandum is not an offer to sell, or an invitation to make an offer to purchase, Shares in Ecuador to, or for the benefit of, any Ecuadorian person or entity. This Memorandum may not be distributed or reproduced, in whole or in part, in Ecuador by the recipients of this Memorandum. This Memorandum has been distributed on the understanding that its recipients will only participate in the issue of Shares outside of Ecuador on their own account and will undertake not to transfer, directly or indirectly, Shares to persons or entities in Ecuador.

FOR PROSPECTIVE SHAREHOLDERS IN EGYPT

Neither this Memorandum nor the Shares have been approved, disapproved or passed on in any way by the Egyptian Financial Supervisory Authority or any other governmental authority in Egypt, nor has the Fund received authorization or licensing from the Egyptian Financial Supervisory Authority or any other governmental authority in Egypt to market or sell Shares within Egypt. This Memorandum does not constitute and may not be used for the purpose of an offer or invitation. No services relating to Shares, including the receipt of applications and the allotment or redemption of such Shares, may be rendered by the Fund within Egypt.

FOR PROSPECTIVE SHAREHOLDERS IN EL SALVADOR

The recipient acknowledges that this Memorandum has been prepared and delivered upon the recipient's request, on a private placement basis.

FOR PROSPECTIVE SHAREHOLDERS IN GUATEMALA

This Memorandum and the Fund herein described have not been nor will they be registered with or approved by the *Registro de Valores y Mercancías* (the Guatemalan Securities and Commodities Market Authority). Accordingly, this Memorandum may not be made available, nor may the Shares be marketed and offered for sale in Guatemala, other than under circumstances which are deemed to constitute a private offering under the Guatemalan Securities and Commodities Market Law (*Ley del Mercado de Valores y Mercancías Decreto 34-96*).

FOR PROSPECTIVE SHAREHOLDERS IN GUERNSEY

Neither the Guernsey Financial Services Commission nor the States of Guernsey Policy Council take any responsibility for the financial soundness of the Fund or for the correctness of any of the statements made or opinions expressed with regard to it. If you are in any doubt about the contents of this memorandum you should consult your accountant, legal or professional adviser or financial adviser. The Investment Manager of the Fund has taken all reasonable care to ensure that the facts stated in this memorandum are true and accurate in all material respects, and that there are no other facts the omission of which would make misleading any statement in this memorandum, whether of fact or opinion. The Investment Manager of the Fund accepts responsibility accordingly. It should be remembered that the price of interests in the Fund can go down as well as up.

FOR PROSPECTIVE SHAREHOLDERS IN HONG KONG

The contents of this Memorandum have not been reviewed or approved by any regulatory authority in Hong Kong. This Memorandum does not constitute an offer or invitation to the public in Hong Kong to acquire Shares. Accordingly, unless permitted by the securities laws of Hong Kong, no person may issue or have in its possession for the purposes of issue, this Memorandum or any advertisement, invitation or document relating to the Shares, whether in Hong Kong or elsewhere, which is directed at, or the contents of which are likely to be accessed or read by, the public in Hong Kong other than in relation to Shares which are intended to be disposed of only to persons outside Hong Kong or only to "professional investors" (as such term is defined in the Securities and Futures Ordinance of Hong Kong (Cap. 571) (the "SFO") and the subsidiary legislation made thereunder) or in circumstances which do not result in this Memorandum being a "prospectus" as defined in the Companies Ordinances of Hong Kong (Cap. 32) (the "CO") or which do not constitute an offer or an invitation to the public for the purposes of the SFO or the CO. The offer of the Shares is personal to the person to whom this Memorandum has been delivered by or on behalf of the Fund, and a subscription for Shares will only be accepted from such person. No person to whom a copy of this Memorandum is issued may issue, circulate or distribute this Memorandum in Hong Kong or make or give a copy of this Memorandum to any other person. You are advised to exercise caution in relation to the offer. If you are in any doubt about any of the contents of this Memorandum, you should obtain independent professional advice.

FOR PROSPECTIVE SHAREHOLDERS IN INDIA

This issue is being made strictly on a private placement basis. This Memorandum is not a prospectus or a statement in lieu of a prospectus. It is not, and should not be deemed to constitute an offer to the public in general. It cannot be acted upon by any person other than the person to whom it has been specifically addressed. Multiple copies hereof given to the same entity will be deemed to be offered to the same person.

The information contained in this Memorandum is believed by the Investment Manager to be accurate in all material respects as of the date hereof. The Investment Manager does not undertake to update this Memorandum to reflect subsequent events. This Memorandum has been prepared to provide general information about the Fund to potential investors evaluating the proposal to subscribe for the Shares and it does not purport to contain all the information that any such potential investor may require. Potential investors should conduct their own due diligence, investigation and analysis of the Investment Manager and the Fund.

Prior to applying for the Shares, potential investors should verify if they have the necessary power and competence to apply for the Shares under their constitutional documents as well as all relevant laws and regulations in force in India, including relevant foreign exchange restrictions and neither the Investment Manager nor the Fund will be responsible for any filings required to be made by the Indian investor. They should also consult their own tax advisers on the tax implications of the acquisition, ownership and sale of Shares, and income arising thereon.

Although the information contained herein has been obtained from sources that are reliable to the best of the Investment Manager's knowledge and belief, the Investment Manager makes no representation as to the accuracy or completeness of any information contained herein or otherwise provided by the Investment Manager. Neither the Investment Manager nor any officer or employee of the Investment Manager accept any liability whatsoever for any direct or consequential loss arising from any use of this Memorandum or its contents.

The Shares have not been registered or listed in any securities exchange.

FOR PROSPECTIVE SHAREHOLDERS IN INDONESIA

This Memorandum is for the exclusive use of the person to whom it has been specifically addressed. The Fund and its affiliates disclaim any responsibility for any copy of this Memorandum that has been improperly reproduced and circulated. This Memorandum may not be photocopied, reproduced or distributed, in whole or in part, to any other person at any time. Distribution of this Memorandum to any person other than in compliance with the terms of this Memorandum is unauthorized. If the offeree does not proceed with the transaction or if it is so requested, it will return this Memorandum to the Investment Manager promptly. Shares will not be offered or sold, directly or indirectly, in the Republic of Indonesia or to Indonesian citizens, nationals or corporations, wherever located, or entities or residents in Indonesia in a manner which constitutes a public offering of the Shares under the laws and regulations of Indonesia.

FOR PROSPECTIVE SHAREHOLDERS IN THE ISLE OF MAN

No public offering of Shares is being made to investors resident in the Isle of Man. Shares are being offered only to institutional investors and a limited number of other investors in the Isle of Man. The Fund is not subject to approval in the Isle of Man and investors are not protected by any statutory compensation arrangements in the event of the Fund's failure. The Isle of Man Financial Services Authority does not vouch for the financial soundness of the Fund or for the correctness of any statement made or opinion expressed with regard to it.

FOR PROSPECTIVE SHAREHOLDERS IN ISRAEL

The Shares have not been registered and are not expected to be registered under the Israeli Securities Law – 1968 (the "Securities Law") or under the Israeli Joint Investment Trust Law – 1994 due to applicable exemptions. Accordingly, the Shares will only be offered and sold in Israel pursuant to applicable private placement exemptions, to parties that qualify as both (i) Sophisticated Investors described in Section 15A(b)(1) of the Securities Law and (ii) as "Qualified Customers" for purposes of Section 3(a)(11) of the Law for the Regulation of Provision of Investment Advice, Marketing Investments and Portfolio Management – 1995 (the "Investment Advisor Law"). Neither the Fund nor the Investment Manager is a licensed investment marketer under the Investment Advisor Law and neither the Fund nor the Investment Manager maintains insurance as required under such law. The Fund and the Investment Manager may be deemed to be providing investment marketing services but are not investment advisors for purposes of Israeli law. Any investment marketing which may be deemed provided under Israeli law in connection with an investment in the Fund is deemed provided on a one time only basis and neither the Fund nor the Investment Manager will provide any ongoing investment marketing or investment advisory services to the investor. If any recipient in Israel of a copy of this Memorandum is not qualified as described above, such recipient should promptly return this Memorandum to the Fund. By retaining a copy of this Memorandum you are hereby confirming that you qualify as both a Sophisticated Investor and Qualified Customer, fully understand the ramifications thereof and agree to be treated as such by the Fund.

FOR PROSPECTIVE SHAREHOLDERS IN JAPAN

No public offering of the Shares is being made to investors resident in Japan and no securities registration statement pursuant to Article 4, paragraph 1, of the Financial Instruments and Exchange Act (the "FIEA") has been made or will be made in respect to the offering of the Shares in Japan. The Shares may not be offered or sold, directly or indirectly, in Japan or to, or for the benefit of, any resident of Japan unless they are offered or sold pursuant to an exemption from the registration requirements of, and in compliance with, the FIEA and any applicable laws and regulations of Japan. Neither the Financial Services Agency of Japan nor the Kanto Local Finance Bureau has passed upon the accuracy or adequacy of this Memorandum or otherwise approved or authorized the offering of the Shares in Japan or to investors resident in Japan.

FOR PROSPECTIVE SHAREHOLDERS IN JERSEY

No public offering of Shares is being made to investors resident in Jersey. Shares are being offered only to a limited number of institutional and sophisticated individual investors in Jersey.

FOR PROSPECTIVE SHAREHOLDERS IN KUWAIT

This Memorandum is not for general circulation to the public in Kuwait. The Shares have not been licensed for offering in Kuwait by the Kuwait Capital Markets Authority, or any other relevant Kuwaiti governmental agency. The offering of the Shares in Kuwait on the basis of a private placement or public offering is, therefore, restricted in accordance with Law No. 7 of 2010 (as amended) and the bylaws thereto (as amended). No private or public offering of the Shares is being made in Kuwait, and no agreement relating to the sale of the Shares will be concluded in Kuwait. No marketing or solicitation or inducement activities are being used to offer or market the Shares in Kuwait.

FOR PROSPECTIVE SHAREHOLDERS IN LEBANON

Neither this Memorandum nor the Shares have been approved, disapproved or passed on in any way by the Lebanese Central Bank (the "BDL"), the Capital Market Authority (the "CMA") or any other governmental authority in Lebanon, nor has the Fund received authorization or licensing from the BDL, the CMA or any other governmental authority in Lebanon to market or sell the Shares within Lebanon. This Memorandum does not constitute and may not be used for the purpose of an offer or invitation. No services relating to the Shares, including the receipt of applications and the allotment or redemption of such Shares, may be rendered by the Fund within Lebanon.

FOR PROSPECTIVE SHAREHOLDERS IN MALAYSIA

The offering made under this Memorandum does not constitute, and should not be construed as constituting an offer or invitation to subscribe for or purchase any securities in Malaysia. The Fund, by the dispatch of this Memorandum, has not made available any securities for subscription or purchase in Malaysia. This Memorandum is distributed in Malaysia for information purposes only. This Memorandum does not constitute and should not be construed as offering or making available any Shares for purchase in Malaysia.

FOR PROSPECTIVE SHAREHOLDERS IN MEXICO

The offering made pursuant to this Memorandum does not constitute a public offering of securities under Mexican law and therefore is not subject to obtaining the prior authorization of the Mexican National Banking and Securities Commission or the registration of Shares with the Mexican National Registry of Securities.

FOR PROSPECTIVE SHAREHOLDERS IN MONACO

No public offering of Shares is being made to investors resident in Monaco. Shares are being offered only to a limited number of institutional investors (i.e., duly licensed banks by the *Autorité de Contrôle Prudentiel* and portfolio management companies duly licensed, by virtue of Law n° 1.338 of September

7th, 2007, by the *Commission de Contrôle des Activités Financières*), capable of understanding the risks of their investment. The *Commission de Contrôle des Activités Financières* of Monaco has not passed upon the accuracy or adequacy of this Memorandum or otherwise approved or authorized the offering of Shares to investors resident in Monaco.

The addressees hereof are perfectly fluent in English and expressly waive the possibility of a French translation of the present document. *Les destinataires du présent document reconnaissent être à même d'en prendre connaissance en langue anglaise et renoncent expressément à une traduction française*.

FOR PROSPECTIVE SHAREHOLDERS IN MOROCCO

No public offering of Shares is being made to investors resident in Morocco. Shares are being offered only to a limited number of institutional investors capable of understanding the risks of their investment. Neither the *Conseil Déontologique des Valeurs Mobilières* nor the Ministry of Finance has passed upon the accuracy or adequacy of this Memorandum or otherwise approved or authorized the offering of Shares to investors resident in Morocco.

FOR PROSPECTIVE SHAREHOLDERS IN NEW ZEALAND

No retail offering of the Shares is being made to investors in New Zealand. The Shares are being offered to wholesale investors in New Zealand pursuant to an exclusion from disclosure requirements under the Financial Markets Conduct Act 2013. The New Zealand Financial Markets Authority has not passed upon the accuracy or adequacy of this Memorandum or otherwise approved or authorized the offering of the Shares to investors resident in New Zealand.

FOR PROSPECTIVE SHAREHOLDERS IN OMAN

This Memorandum, and the Shares to which it relates, may not be advertised, marketed, distributed or otherwise made available to the general public in Oman. In connection with the offering of the Shares, no prospectus has been registered with or approved by the Central Bank of Oman, the Oman Ministry of Commerce and Industry, the Oman Capital Market Authority or any other regulatory body in the Sultanate of Oman. The offering and sale of the Shares described in this Memorandum will not take place inside Oman. The Shares are being offered on a limited private basis, and do not constitute marketing, offering or sales to the general public in Oman. Therefore, this Memorandum is strictly private and confidential, and is being issued to a limited number of sophisticated investors, and may neither be reproduced, used for any other purpose, nor provided to any other person than the intended recipient hereof.

FOR PROSPECTIVE SHAREHOLDERS IN PANAMA

No public offering of Shares is being made to investors resident in Panama. The Shares are being offered only to institutional investors and a limited number of other investors in Panama. The *Superintendencia del Mercado de Valores* has not passed upon the accuracy or adequacy of this Memorandum or otherwise approved or authorized the offering of Shares to investors resident in Panama.

FOR PROSPECTIVE SHAREHOLDERS IN PERU

Shares have not been and will not be approved by the Peruvian *Superintendencia del Mercado de Valores* ("SMV") or any other regulatory agency in Peru, nor have they been registered under the Securities Market Law (*Ley del Mercado de Valores*), or any SMV regulations. Shares may not be offered or sold within Peru except in private placement transactions.

FOR PROSPECTIVE SHAREHOLDERS IN THE PHILIPPINES

The Shares being offered or sold have not been registered with the Philippine Securities and Exchange Commission under the Philippine Securities Regulation Code (the "SRC"). Any future offer or sale thereof is subject to registration requirements under the SRC unless such offer or sale qualifies as an exempt transaction.

FOR PROSPECTIVE SHAREHOLDERS IN QATAR

This Memorandum is provided on an exclusive basis to the specifically intended recipient hereof, upon that person's request and initiative and for the recipient's personal use only. Nothing in this Memorandum constitutes, is intended to constitute, shall be treated as constituting or shall be deemed to constitute any offer or sale of securities in the State of Qatar or in the Qatar Financial Centre or the inward marketing of an investment fund, or an attempt to do business as a bank, an investment company or otherwise in the State of Qatar or in the Qatar Financial Centre, other than in compliance with any laws applicable in the State of Qatar or in the Qatar Financial Centre governing the issue, offering and sale of securities.

This Memorandum and the underlying instruments have not been approved, registered or licensed by the Qatar Central Bank, the Qatar Financial Centre Regulatory Authority, the Qatar Financial Markets Authority or any other regulator in the State of Qatar. The Memorandum and any related documents have not been reviewed or approved by the Qatar Financial Centre Regulatory Authority or the Qatar Central Bank.

Recourse against the Fund, and those involved with it, may be limited or difficult and may have to be pursued in a jurisdiction outside Qatar and the Qatar Financial Centre. Any distribution of this Memorandum by the recipient to third parties in Qatar or the Qatar Financial Centre beyond the terms hereof is not authorized and shall be at the liability of the recipient.

FOR PROSPECTIVE SHAREHOLDERS IN THE RUSSIAN FEDERATION

Under Russian law, the Shares may be considered securities of a foreign issuer. Neither the Shares nor this Memorandum has been, or is intended to be, registered with the Central Bank of the Russian Federation, and hence the Shares are not eligible for advertising, initial placement and public circulation in the Russian Federation and may not be offered to investors that are not qualified investors within the meaning of Russian law. The information provided in this Memorandum (including any amendment or supplement thereto or replacement thereof) is not an offer, or an invitation to make offers, to sell, exchange or otherwise transfer the Shares in the Russian Federation to or for the benefit of any Russian person or entity.

This Memorandum is not to be distributed or reproduced (in whole or in part) in the Russian Federation by the recipients of this Memorandum. This Memorandum has been distributed on the understanding that its recipients will only participate in the issue of the Shares outside the Russian Federation on their own account and undertake not to transfer, directly or indirectly, the Shares in the Russian Federation for public circulation or offering to non-qualified investors.

FOR PROSPECTIVE SHAREHOLDERS IN SAUDI ARABIA

Neither this Memorandum nor the Shares have been approved, disapproved or passed on in any way by the Capital Market Authority or any other governmental authority in the Kingdom of Saudi Arabia, nor has the Fund received authorization or licensing from the Capital Market Authority or any other governmental authority in the Kingdom of Saudi Arabia to market or sell the Shares within the Kingdom of Saudi Arabia. This Memorandum does not constitute and may not be used for the purpose of an offer or invitation. No services relating to the Shares, including the receipt of applications and the allotment or redemption of the Shares, may be rendered by the Fund within the Kingdom of Saudi Arabia.

FOR PROSPECTIVE SHAREHOLDERS IN SINGAPORE

This Memorandum and any other material in connection with the offer or sale is not a prospectus as defined in the Securities and Futures Act, Chapter 289 of Singapore (the "SFA"). Accordingly, statutory liability under the SFA in relation to the content of prospectuses would not apply. You should consider carefully whether the investment is suitable for you.

This Memorandum has not been registered as a prospectus with the Monetary Authority of Singapore (the "MAS") and this offering is not regulated by any financial supervisory authority pursuant to any legislation in Singapore. The Fund is not authorized or recognized by the MAS and the Shares are not allowed to be offered to the retail public. Accordingly, this Memorandum and any other document or material in connection with the offer or sale, or invitation for subscription or purchase, of the Shares may not be circulated or distributed, nor may the Shares be offered or sold, or be made the subject of an invitation for subscription or purchase, whether directly or indirectly, to persons in Singapore other than (i) to an institutional investor under Section 4A of the SFA, (ii) to a relevant person under Section 305(1) of the SFA, (iii) to any person pursuant to an offer referred to in Section 305(2) of the SFA, or (iv) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA. Since this Memorandum is not a prospectus as defined in the SFA, statutory liability under the SFA in relation to the content of prospectuses does not apply, and investors should consider carefully whether the investment is suitable for them.

Certain resale restrictions apply to the offer and investors are advised to acquaint themselves with such restrictions.

Where the Shares are subscribed or purchased under Section 305 of the SFA by a relevant person which is:

(a) a corporation (which is not an accredited investor (as defined in Section 4A of the SFA)) the sole business of which is to hold investments and the entire share capital of which is owned by one or more individuals, each of whom is an accredited investor; or

(b) a trust (where the trustee is not an accredited investor) whose sole purpose is to hold investments and each beneficiary of the trust is an individual who is an accredited investor,

shares, debentures and units of shares and debentures of that corporation or the beneficiaries' rights and interest (howsoever described) in that trust shall not be transferred within 6 months after that corporation or that trust has acquired the interests pursuant to an offer made under Section 305 except:

(1) to an institutional investor or to a relevant person defined in Section 305(5) of the SFA, or to any person pursuant to an offer that is made on terms that such shares, debentures and units of shares and debentures of that corporation or such rights and interest in that trust are acquired at a consideration of not less than S$200,000 (or its equivalent in a foreign currency) for each transaction, whether such amount is to be paid for in cash or by exchange of units in a collective investment scheme, securities, securities-based derivatives contracts or other assets, and further for corporations, in accordance with the conditions specified in Section 305(3) of the SFA;

(2) where no consideration is or will be given for the transfer;

(3) where the transfer is by operation of law;

(4) as specified in Section 305A(5) of the SFA;

(5) as specified in Regulation 36 and 36A of the Securities and Futures (Offers of Investments) (Collective Investment Schemes) Regulations 2005 of Singapore.

This offer is made in reliance on the exemption for restricted schemes under section 305 of the SFA. The scheme has not been entered into the list of restricted schemes maintained by the MAS. The MAS does not regulate the manager in respect of the management of the scheme.

FOR PROSPECTIVE SHAREHOLDERS IN SOUTH AFRICA

Neither this Memorandum nor the Shares have been approved, disapproved or passed on in any way by the Financial Services Conduct Authority or any other governmental authority in South Africa, nor has the Fund received authorization or licensing from the Financial Services Conduct Authority or any other governmental authority in South Africa to market or sell Shares within South Africa. This Memorandum is strictly confidential and may not be reproduced, used for any other purpose or provided to any person other than the intended recipient.

FOR PROSPECTIVE SHAREHOLDERS IN SOUTH KOREA

Neither the Fund nor any of its affiliates is making any representation with respect to the eligibility of any recipients of this Memorandum to acquire the Shares under the laws of Korea, including the Foreign Exchange Transaction Law and Regulations thereunder. The Shares are being offered and sold in Korea only to persons prescribed by Article 301, Paragraph 2 of the Enforcement Decree of the Financial Investment Services and Capital Markets Act, and none of the Shares may be offered, sold or delivered, or offered or sold to any person for re-offering or resale, directly or indirectly, in Korea or to any resident of Korea except pursuant to applicable laws and regulations of Korea. Furthermore, the Shares may not be re-sold to Korean residents unless the purchaser of the Shares complies with all applicable regulatory requirements (including governmental approval requirements under the Foreign Exchange Transaction Law and its subordinate decrees and regulations) in connection with purchase of the Shares.

FOR PROSPECTIVE SHAREHOLDERS IN SWITZERLAND

The Fund has not been and cannot be registered with the Swiss Financial Market Supervisory Authority-FINMA and the Shares cannot be offered in Switzerland to non-qualified investors. The offering of the Fund into Switzerland is exempt from the prospectus requirement under the Swiss Financial Services Act dated June 15, 2018 (the "**FinSA**"). No prospectus pursuant to the FinSA has been or will be prepared for or in connection with the offering of the Fund. This Memorandum and/or any other offering materials relating to the Fund may be made available in Switzerland solely to investors that invest in the Fund on their own initiative in a manner that does not involve any offering.

FOR PROSPECTIVE SHAREHOLDERS IN THAILAND

This Memorandum is provided to you solely at your request and is not intended to be an offer, sale or invitation for subscription or purchase of securities in Thailand. This Memorandum has not been registered as a prospectus with the Office of the Securities and Exchange Commission of Thailand. Accordingly, this Memorandum and any other documents and material in connection with the offer, sale or invitation for subscription or purchase, of the Shares may not be circulated or distributed, nor may Shares be offered or sold, or be made the subject of an invitation for subscription or purchase, whether directly or indirectly, to the public or any members of the public in Thailand. Neither the Fund, any of its affiliates or any of their respective representatives maintain any license, authorization or registration in Thailand nor is the Fund registered in Thailand. The offer and sale of securities within Thailand and the provision of securities services in Thailand or to Thai persons or entities may not be possible or may be subject to legal restriction or conditions.

FOR PROSPECTIVE SHAREHOLDERS IN TURKEY

An issuance certificate relating to the Shares has not been approved by the Turkish Capital Markets Board pursuant to the provisions of the Capital Markets Law. No offering or other sale or solicitation will be made until an issuance certificate relating to the Shares has been approved by the Turkish Capital Markets Board pursuant to the provisions of the Capital Markets Law. The Shares may be offered in Turkey only to qualified investors, as this term is provided in Article 30 of the Foreign Securities and Mutual Funds Communiqué and as defined in applicable capital markets regulations. Each investor in the Fund in Turkey will be required to provide documents evidencing that it is a qualified investor pursuant to Article 30 of the Foreign Securities and Mutual Funds Communiqué. Qualified investors are presumed to be aware that the Fund has not made any advertisement or public disclosure, and should request any information necessary to make an informed investment decision directly from the Fund. The approval by the Capital Markets Board of an issuance certificate would not constitute a guarantee by the Capital Markets Board in relation to the Shares. This Memorandum is not intended to be an advertisement, promotion or solicitation of the Fund or any Shares. The Capital Markets Board or Borsa Istanbul does not have any discretion relating to the determination of the price of the Shares.

FOR PROSPECTIVE SHAREHOLDERS IN THE UNITED ARAB EMIRATES (ABU DHABI AND DUBAI OUTSIDE OF THE DUBAI INTERNATIONAL FINANCIAL CENTRE)

By receiving this Memorandum, the person or entity to whom it has been issued understands, acknowledges and agrees that neither this Memorandum nor the Shares have been approved, disapproved or passed on in any way by the Central Bank of the United Arab Emirates (the "UAE"), the UAE Securities and Commodities Authority (the "SCA") or any other authority in the UAE, nor has the entity conducting the placement in the UAE received authorization or licensing from the Central Bank of the UAE, the SCA or any other authority in the UAE to market or sell the Shares within the UAE. The SCA accepts no liability in relation to the Fund and is not making any recommendation with respect to an investment in the Fund. No services relating to the Shares, including the receipt of applications and/or the allotment or redemption of such Shares, have been or will be rendered within the UAE by the Fund. Nothing contained in this Memorandum is intended to constitute UAE investment, legal, tax, accounting or other professional advice. This Memorandum is for the information of prospective investors only and nothing in this Memorandum is intended to endorse or recommend a particular course of action. Prospective investors should consult with an appropriate professional for specific advice rendered on the basis of their situation. No offer or invitation to subscribe for Shares or sale of Shares has been or will be rendered in, or to any persons in, or from, the Dubai International Finance Centre.

FOR PROSPECTIVE SHAREHOLDERS IN THE UNITED ARAB EMIRATES (IN THE DUBAI INTERNATIONAL FINANCIAL CENTRE)

This Memorandum relates to the Fund, which is not subject to any form of regulation or approval by the Dubai Financial Services Authority (the "DFSA"). The DFSA has no responsibility for reviewing or verifying this Memorandum or any other documents in connection with the Fund. Accordingly, the DFSA has not approved this Memorandum or any other associated documents nor taken any steps to verify the information set out in this Memorandum, and has no responsibility for it. The Shares to which this Memorandum relates may be illiquid and/or subject to restrictions on their resale. Prospective purchasers should conduct their own due diligence with respect to the Shares. Shares are not being offered to "retail clients" as defined in the Conduct of Business Module of the DFSA. If you do not understand the contents of this Memorandum you should consult an authorized financial adviser.

FOR PROSPECTIVE SHAREHOLDERS IN THE UNITED KINGDOM

In the United Kingdom, this Memorandum is only available to persons who are (i) investment professionals within the meaning of Article 19 of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the "FPO") or Article 14 of the Financial Services and Markets Act 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order 2001 (the "PCIS Order"), as applicable; (ii) high net worth companies and certain other entities falling within Article 49 of the FPO or Article 22 of the PCIS Order; or (iii) any other persons to whom the Shares may lawfully be promoted. It must not be acted, or relied upon by any other persons. The Fund has not been authorized or recognized by the Financial Conduct Authority and investors will not have the benefit of the Financial Services Compensation Scheme or other protections afforded of the United Kingdom regulatory system.

FOR PROSPECTIVE SHAREHOLDERS IN URUGUAY

The Fund is not established under the system provided by Uruguayan Law 16,774 of September 27, 1996, and has not been registered with the Central Bank of Uruguay. The Shares have not been registered with the Central Bank of Uruguay and will not be offered or sold in Uruguay through public offering.

Title 17: Commodity and Securities Exchanges
PART 4—COMMODITY POOL OPERATORS AND COMMODITY TRADING ADVISORS
Subpart A—General Provisions, Definitions and Exemptions

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§4.5 Exclusion for certain otherwise regulated persons from the definition of the term "commodity pool operator."

(a) Subject to compliance with the provisions of this section, the following persons, and any principal or employee thereof, shall be excluded from the definition of the term "commodity pool operator" with respect to the operation of a qualifying entity specified in paragraph (b) of this section:

(1) An investment adviser registered under the Investment Advisers Act of 1940, as amended;

(2) An insurance company subject to regulation by any State;

(3) A bank, trust company or any other such financial depository institution subject to regulation by any State or the United States; and

(4) A trustee of, a named fiduciary of (or a person designated or acting as a fiduciary pursuant to a written delegation from or other written agreement with the named fiduciary) or an employer maintaining a pension plan that is subject to title I of the Employee Retirement Income Security Act of 1974; *Provided, however,* That for purposes of this §4.5 the following employee benefit plans shall not be construed to be pools:

(i) A noncontributory plan, whether defined benefit or defined contribution, covered under title I of the Employee Retirement Income Security Act of 1974;

(ii) A contributory defined benefit plan covered under title IV of the Employee Retirement Income Security Act of 1974; *Provided, however,* That with respect to any such plan to which an employee may voluntarily contribute, no portion of an employee's contribution is committed as margin or premiums for futures or options contracts;

(iii) A plan defined as a governmental plan in section 3(32) of title I of the Employee Retirement Income Security Act of 1974;

(iv) Any employee welfare benefit plan that is subject to the fiduciary responsibility provisions of the Employee Retirement Income Security Act of 1974; and

(v) A plan defined as a church plan in Section 3(33) of title I of the Employee Retirement Income Security Act of 1974 with respect to which no election has been made under 26 U.S.C. 410(d).

(b) For the purposes of this section, the term “qualifying entity” means:

(1) With respect to any person specified in paragraph (a)(1) of this section, an investment company registered under the Investment Company Act of 1940, as amended, or a business development company that elected an exemption from registration as an investment company under the Investment Company Act of 1940;

(2) With respect to any person specified in paragraph (a)(2) of this section, a separate account established and maintained or offered by an insurance company pursuant to the laws of any State or territory of the United States, under which income gains and losses, whether or not realized, from assets allocated to such account, are, in accordance with the applicable contract, credited to or charged against such account, without regard to other income, gains, or losses of the insurance company;

(3) With respect to any person specified in paragraph (a)(3) of this section, the assets of any trust, custodial account or other separate unit of investment for which it is acting as a fiduciary and for which it is vested with investment authority; and

(4) With respect to any person specified in paragraph (a)(4) of this section, and subject to the proviso thereof, a pension plan that is subject to title I of the Employee Retirement Income Security Act of 1974; *Provided, however,* That such entity will be operated in the manner specified in paragraph (c)(2) of this section.

(c) Any person who desires to claim the exclusion provided by this section shall file electronically a notice of eligibility with the National Futures Association through its electronic exemption filing system; *Provided, however*, That a plan fiduciary who is not a named fiduciary as described in paragraph (a)(4) of this section may claim the exclusion through the notice filed by the named fiduciary.

(1) The notice of eligibility must contain the following information:

(i) The name of such person;

(ii) The applicable subparagraph of paragraph (a) of this section pursuant to which such person is claiming exclusion;

(iii) The name of the qualifying entity which such person intends to operate pursuant to the exclusion; and

(iv) The applicable subparagraph of paragraph (b) of this section pursuant to which such entity is a qualifying entity.

(2) The notice of eligibility must contain representations that such person will operate the qualifying entity specified therein in the following ways, as applicable:

(i) The person will disclose in writing to each participant, whether existing or prospective, that the qualifying entity is operated by a person who has claimed an exclusion from the definition of the term “commodity pool operator” under the Act and, therefore, is not subject to registration or regulation as a pool operator under the Act; Provided, that such disclosure is made in accordance with the requirements of any other federal or state regulatory authority to which the qualifying entity is subject. The qualifying entity may make such disclosure by including the information in any document that its other Federal or State regulator requires to be furnished routinely to participants or, if no such document is furnished routinely, the information may be disclosed in any instrument establishing the entity's investment policies and objectives that the other regulator requires to be made available to the entity's participants; and

(ii) The person will submit to such special calls as the Commission may make to require the qualifying entity to demonstrate compliance with the provisions of this paragraph (c); Provided, however, that the making of such representations shall not be deemed a substitute for compliance with any criteria applicable to commodity futures or commodity options trading established by any regulator to which such person or qualifying entity is subject; and

(iii) If the person is an investment adviser claiming an exclusion with respect to the operation of a qualifying entity under paragraph (b)(1) of this section, then the notice of eligibility must also contain representations that such person will operate that qualifying entity in a manner such that the qualifying entity:

(A) Will use commodity futures or commodity options contracts, or swaps solely for bona fide hedging purposes within the meaning and intent of the definition of bona fide hedging transactions and positions for excluded commodities in §§1.3 and 151.5 of this chapter; Provided however, That, in addition, with respect to positions in commodity futures or commodity options contracts, or swaps which do not come within the meaning and intent of the definition of bona fide hedging transactions and positions for excluded commodities in §§1.3 and 151.5 of this chapter, a qualifying entity may represent that the aggregate initial margin and premiums required to establish such positions will not exceed five percent of the liquidation value of the qualifying entity's portfolio, after taking into account unrealized profits and unrealized losses on any such contracts it has entered into; and, Provided further, That in the case of an option that is in-the-money at the time of the purchase, the in-the-money amount as defined in §190.01of this chapter may be excluded in computing such five percent; or

(B) The aggregate net notional value of commodity futures, commodity options contracts, or swaps positions not used solely for bona fide hedging purposes within the meaning and intent of the definition of bona fide hedging transactions and positions for excluded commodities in §§1.3 and 151.5 of this chapter determined at the time the most recent position was established, does not exceed 100 percent of the liquidation value of the pool's portfolio, after taking into account unrealized profits and unrealized losses on any such positions it has entered into. For purposes of this paragraph:

(*1*) The term “notional value” shall be calculated for each futures position by multiplying the number of contracts by the size of the contract, in contract units (taking into account any multiplier specified in the contract), by the current market price per unit, for each such option position by multiplying the number of contracts by the size of the contract, adjusted by its delta, in contract units (taking into account any multiplier specified in the contract), by the strike price per unit, for each such retail forex transaction, by calculating the value in U.S. Dollars for such transaction, at the time the transaction was established, excluding for this purpose the value in U.S. Dollars of offsetting long and short transactions, if any, and for any cleared swap by the value as determined consistent with the terms of 17 CFR part 45; and

(*2*) The person may net futures contracts with the same underlying commodity across designated contract markets and foreign boards of trade; and swaps cleared on the same designated clearing organization where appropriate; and (C) Will not be, and has not been, marketing participations to the public as or in a commodity pool or otherwise as or in a vehicle for trading in the commodity futures, commodity options, or swaps markets.

(3) The notice of eligibility must be filed with the National Futures Association prior to the date upon which such person intends to operate the qualifying entity pursuant to the exclusion provided by this section.

(4) The notice of eligibility shall be effective upon filing.

(5) *Annual notice.* Each person who has filed a notice of exclusion under this section must affirm on an annual basis the notice of exemption from registration, withdraw such exemption due to the cessation of activities requiring registration or exemption therefrom, or withdraw such exemption and apply for registration within 60 days of the calendar year end through National Futures Association's electronic exemption filing system.

(d)(1) Each person who has claimed an exclusion hereunder must, in the event that any of the information contained or representations made in the notice of eligibility becomes inaccurate or incomplete, amend the notice electronically through National Futures Association's electronic exemption filing system as may be necessary to render the notice of eligibility accurate and complete.

(2) This amendment required by paragraph (d)(1) of this section shall be filed within fifteen business days after the occurrence of such event.

(e) An exclusion claimed hereunder shall cease to be effective upon any change which would render:

(1) A person as to whom such exclusion has been claimed ineligible under paragraph (a) of this section;

(2) The entity for which such exclusion has been claimed ineligible under paragraph (b) of this section; or

(3) Either the representations made pursuant to paragraph (c)(2) of this section inaccurate or the continuation of such representations false or misleading.

(f) Any notice required to be filed hereunder must be filed by a representative duly authorized to bind the person specified in paragraph (a) of this section.

(g) The filing of a notice of eligibility or the application of "non-pool status" under this section will not affect the ability of a person to qualify for an exemption from registration as a commodity pool operator under §4.13 in connection with the operation of another trading vehicle that is not covered under this §4.5.

[50 FR 15882, Apr. 23, 1985; 50 FR 18859, May 3, 1985, as amended at 58 FR 6374, Jan. 28, 1993; 58 FR 43793, Aug. 18, 1993; 65 FR 24128, Apr. 25, 2000; 65 FR 25980, May 4, 2000; 67 FR 77410, Dec. 18, 2002; 68 FR 47230, Aug. 8, 2003; 72 FR 1662, Jan. 16, 2007; 77 FR 11283, Feb. 24, 2012; 77 FR 17328, Mar. 26, 2012; 83 FR 7995, Feb. 23, 2018; 84 FR 67353, Dec. 10, 2019; 86 FR 19420, Apr. 13, 2021]

Title 17: Commodity and Securities Exchanges
PART 4—COMMODITY POOL OPERATORS AND COMMODITY TRADING ADVISORS
Subpart A—General Provisions, Definitions and Exemptions

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§4.13 Exemption from registration as a commodity pool operator.

This section is organized as follows: Paragraph (a) of this section specifies the criteria that must be met to qualify for exemption from registration under this section; paragraph (b) of this section governs the notice that must be filed to claim exemption from registration; paragraph (c) of this section sets forth the continuing obligations of a person who has claimed exemption under this section; paragraph (d) of this section specifies information certain persons must provide if they subsequently register; paragraph (e) of this section specifies the effect of registration on a person who has claimed an exemption from registration under this section or who is eligible to claim an exemption from registration hereunder; and paragraph (f) of this section specifies the effect of this section on §4.5 of this chapter.

(a) A person is not required to register under the Act as a commodity pool operator if:

(1)(i) It does not receive any compensation or other payment, directly or indirectly, for operating the pool, except reimbursement for the ordinary administrative expenses of operating the pool;

(ii) It operates only one commodity pool at any time;

(iii) It is not otherwise required to register with the Commission and is not a business affiliate of any person required to register with the Commission; and

(iv) Neither the person nor any other person involved with the pool does any advertising in connection with the pool (for purposes of this section, advertising includes the systematic solicitation of prospective participants by telephone or seminar presentation);

(2)(i) None of the pools operated by it has more than 15 participants at any time; and

(ii) The total gross capital contributions it receives for units of participation in all of the pools it operates or that it intends to operate do not in the aggregate exceed $400,000.

(iii) For the purpose of determining eligibility for exemption under paragraph (a)(2) of this section, the person may exclude the following participants and their contributions:

(A) The pool's operator, commodity trading advisor, and the principals thereof;

(B) A child, sibling or parent of any of these participants;

(C) The spouse of any participant specified in paragraph (a)(2)(iii)(A) or (B) of this section; and

(D) Any relative of a participant specified in paragraph (a)(2)(iii)(A), (B) or (C) of this section, its spouse or a relative of its spouse, who has the same principal residence as such participant;

(3) For each pool for which the person claims exemption from registration under this paragraph (a)(3):

(i) Interests in the pool are exempt from registration under the Securities Act of 1933, and the interests are marketed and advertised to the public in the United States solely, if at all, in compliance with §230.506(c) of this title, or with Rule 144A, §230.144A of this title, as applicable;

(ii) At all times, the pool meets one or the other of the following tests with respect to its commodity interest positions, including positions in security futures products, whether entered into for *bona fide* hedging purposes or otherwise:

(A) The aggregate initial margin, premiums, and required minimum security deposit for retail forex transactions (as defined in §5.1(m) of this chapter) required to establish such positions, determined at the time the most recent position was established, will not exceed 5 percent of the liquidation value of the pool's portfolio, after taking into account unrealized profits and unrealized losses on any such positions it has entered into; *Provided,* That in the case of an option that is in-the-money at the time of purchase, the in-the-money amount as defined in §190.01 of this chapter may be excluded in computing such 5 percent; or

(B) The aggregate net notional value of such positions, determined at the time the most recent position was established, does not exceed 100 percent of the liquidation value of the pool's portfolio, after taking into account unrealized profits and unrealized losses on any such positions it has entered into. For the purpose of this paragraph:

(*1*) The term “notional value” shall be calculated for each futures position by multiplying the number of contracts by the size of the contract, in contract units (taking into account any multiplier specified in the contract), by the current market price per unit, for each such option position by multiplying the number of contracts by the size of the contract, adjusted by its delta, in contract units (taking into account any multiplier specified in the contract), by the strike price per unit, for each such retail forex transaction, by calculating the value in U.S. Dollars of such transaction, at the time the transaction was established, excluding for this purpose the value in U.S. Dollars of offsetting long and short transactions, if any, and for any cleared swap by the value as determined consistent with the terms of 17 CFR part 45; and

(*2*) The person may net futures contracts with the same underlying commodity across designated contract markets and foreign boards of trade; and swaps cleared on the same derivatives clearing organization where appropriate; and

(iii) The person reasonably believes, at the time of investment (or, in the case of an existing pool, at the time of conversion to a pool meeting the criteria of paragraph (a)(3) of this section), that each person who participates in the pool is:

(A) An “accredited investor,” as that term is defined in §230.501 of this title;

(B) A trust that is not an accredited investor but that was formed by an accredited investor for the benefit of a family member;

(C) A “knowledgeable employee,” as that term is defined in §270.3c-5 of this title; or

(D) A “qualified eligible person,” as that term is defined in §4.7; and

(iv) Participations in the pool are not marketed as or in a vehicle for trading in the commodity futures or commodity options markets; *Provided,* That nothing in paragraph (a)(3) of this section shall prohibit the person from claiming an exemption under this section if it additionally operates one or more pools for which it meets the criteria of paragraph (a)(4) of this section;

(4) [Reserved]

(5) The person is acting as a director or trustee with respect to a pool whose operator is registered as a commodity pool operator and is eligible to claim relief under §4.12(c) of this chapter, *Provided, however,* that:

(i) The person acts in such capacity solely to comply with the requirements under section 10A of the Securities Exchange Act of 1934, as amended, and any Securities and Exchange Commission rules and exchange listing requirements adopted pursuant thereto, that the pool have an audit committee comprised exclusively of independent directors or trustees;

(ii) The person has no power or authority to manage or control the operations or activities of the pool except as necessary to comply with such requirement; and

(iii) The registered pool operator of the pool is and will be liable for any violation of the Act or the Commission's regulations by the person in connection with the person's serving as a director or trustee with respect to the pool.

(6) For each pool for which the person claims exemption under this paragraph (a)(6):

(i) Interests in the pool are exempt from registration under the Securities Act of 1933, and such interests are offered and sold only to “family clients,” as defined in §275.202(a)(11)(G)-1 of this title;

(ii) The person qualifies as a “family office,” as defined in §275.202(a)(11)(G)-1 of this title; and

(iii) The person reasonably believes, at the time of investment, or in the case of an existing pool, at the time of conversion to a pool meeting the criteria of this paragraph (a)(6) of this section, that each person who participates in the pool is a “family client” of the “family office,” as defined in §275.202(a)(11)(G)-1 of this title.

(7)(i) Eligibility for exemption under paragraph (a)(1), (a)(2), (a)(3) or (a)(4) of this section is subject to the person furnishing in written communication physically delivered or delivered through electronic transmission to each prospective participant in the pool:

(A) A statement that the person is exempt from registration with the Commission as a commodity pool operator and that therefore, unlike a registered commodity pool operator, it is not required to deliver a Disclosure Document and a certified annual report to participants in the pool; and

(B) A description of the criteria pursuant to which it qualifies for such exemption from registration.

(ii) The person must make these disclosures by no later than the time it delivers a subscription agreement for the pool to a prospective participant in the pool.

(b)(1) Any person who desires to claim the relief from registration provided by this section, except for any person claiming the exemption for family offices in paragraph (a)(6) of this section, must file electronically a notice of exemption from commodity pool operator registration with the National Futures Association through its electronic exemption filing system. The notice must:

(i) Provide the name, main business address, main business telephone number, main facsimile number and main email address of the person claiming the exemption and the name of the pool for which it is claiming exemption;

(ii) Specify the paragraph number pursuant to which the person is filing the notice (*i.e.,* §4.13(a)(1), (2), (3), or (5)) and represent that the pool will be operated in accordance with the criteria of that paragraph;

(iii) Represent that neither the person nor any of its principals has in its background a statutory disqualification that would require disclosure under section 8a(2) of the Act if such person sought registration, unless such disqualification arises from a matter which was disclosed in connection with a previous application for registration, where such registration was granted; and

(iv) Be filed by a representative duly authorized to bind the person.

(2) The person must file the notice by no later than the time that the pool operator delivers a subscription agreement for the pool to a prospective participant in the pool; *Provided, however,* that in the case of a claim for relief under §4.13(a)(5), the person must file the notice by the later of the effective date of the pool's registration statement under the Securities Act of 1933 or the date on which the person first becomes a director or trustee; and *Provided, further,* that where a person registered with the Commission as a commodity

pool operator intends to withdraw from registration in order to claim exemption hereunder, the person must notify its pool's participants in written communication physically delivered or delivered through electronic transmission that it intends to withdraw from registration and claim the exemption, and it must provide each such participant with a right to redeem its interest in the pool prior to the person filing a notice of exemption from registration

(3) The notice will be effective upon filing, provided the notice is materially complete.

(4) *Annual notice.* Each person who has filed a notice of exemption from registration under this section must affirm on an annual basis the notice of exemption from registration, withdraw such exemption due to the cessation of activities requiring registration or exemption therefrom, or withdraw such exemption and apply for registration within 60 days of the calendar year end through National Futures Association's electronic exemption filing system.

(5) Each person who has filed a notice of exemption from registration under this section must, in the event that any of the information contained or representations made in the notice becomes inaccurate or incomplete, amend the notice through National Futures Association's electronic exemption filing system as may be necessary to render the notice accurate and complete. This amendment must be filed electronically within 15 business days after the pool operator becomes aware of the occurrence of such event.

(c)(1) Each person who has claimed an exemption from registration under this section must:

(i) Make and keep all books and records prepared in connection with its activities as a pool operator for a period of five years from the date of preparation;

(ii) Keep such books and records readily accessible during the first two years of the five-year period. All such books and records must be available for inspection upon the request of any representative of the Commission, the United States Department of Justice, or any other appropriate regulatory agency; and

(iii) Submit to such special calls as the Commission may make to demonstrate eligibility for and compliance with the applicable criteria for exemption under this section.

(2) Each person who has filed a notice of exemption from registration pursuant to paragraph (a)(1) or (a)(2) of this section must:

(i) Promptly furnish to each participant in the pool a copy of each monthly statement for the pool that the pool operator received from a futures commission merchant pursuant to §1.33 of this chapter; and

(ii) Clearly show on such statement, or on an accompanying supplemental statement, the net profit or loss on all commodity interests closed since the date of the previous statement.

(d) Each person who applies for registration as a commodity pool operator subsequent to claiming relief under paragraph (a)(1) or (a)(2) of this section must include with its application the financial statements and other information required by §4.22(c)(1) through (5) for each pool that it has operated as an operator exempt from registration. That information must be presented and computed in accordance with generally accepted accounting principles consistently applied. If the person is granted registration as a commodity pool operator, it must comply with the provisions of this part with respect to each such pool.

(e)(1) Subject to the provisions of paragraph (e)(2) of this section, if a person who is eligible for exemption from registration as a commodity pool operator under this section nonetheless registers as a commodity pool operator, the person must comply with the provisions of this part with respect to each commodity pool identified on its registration application or supplement thereto.

(2) If a person operates one or more commodity pools described in paragraph (a)(3) of this section, and one or more commodity pools for which it must be, and is, registered as a commodity pool operator, the person is exempt from the requirements applicable to a registered commodity pool operator with respect to the pool or pools described in paragraph (a)(3) of this section; *Provided,* That the person:

(i) Furnishes in written communication physically delivered or delivered through electronic transmission to each prospective participant in a pool described in paragraph (a)(3) of this section that it operates:

(A) A statement that it will operate the pool as if the person was exempt from registration as a commodity pool operator;

(B) A description of the criteria pursuant to which it will so operate the pool;

(ii) Complies with paragraph (c) of this section; and

(iii) Provides each existing participant in a pool that the person elects to operate as described in paragraph (a)(3) of this section a right to redeem the participant's interest in the pool, and informs each such participant of that right no later than the time the person commences to operate the pool as described in paragraph (a)(3) of this section.

(f) The filing of a notice of exemption from registration under this section will not affect the ability of a person to qualify for exclusion from the definition of the term “commodity pool operator” under §4.5 in connection with its operation of another trading vehicle that is not covered under this §4.13.

(Approved by the Office of Management and Budget under control number 3038-0005)

(Secs. 2(a)(1), 4c(a)-(d), 4d, 4f, 4g, 4k, 4m, 4n, 8a, 15 and 17, Commodity Exchange Act (7 U.S.C. 2, 4, 6c(a)-(d), 6f, 6g, 6k, 6m, 6n, 12a, 19 and 21; 5 U.S.C. 552 and 552b))

[46 FR 26013, May 8, 1981, as amended at 46 FR 63035, Dec. 30, 1981; 47 FR 57011, Dec. 22, 1982; 50 FR 15883, Apr. 23, 1985; 67 FR 77411, Dec. 18, 2002; 68 FR 47231, Aug. 8, 2003; 68 FR 59113, Oct. 14, 2003; 69 FR 41426, July 9, 2004; 72 FR 1663, Jan. 16, 2007; 74 FR 57590, Nov. 9, 2009; 75 FR 55428, Sept. 10, 2010; 76 FR 28645, May 18, 2011; 77 FR 11284, Feb. 24, 2012; 77 FR 17329, Mar. 26, 2012; 84 FR 67368, Dec. 10, 2019; 85 FR 40890, July 8, 2020; 86 FR 19421, Apr. 13, 2021]

Apr. 13, 2021]

Need assistance?

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

COMMODITY FUTURES TRADING COMMISSION, Plaintiff, v. GELFMAN BLUEPRINT, INC., and NICHOLAS GELFMAN, Defendants.	Case No. 17-7181 ECF Case **COMPLAINT FOR INJUNCTIVE AND OTHER EQUITABLE RELIEF AND FOR CIVIL MONETARY PENALTIES UNDER THE COMMODITY EXCHANGE ACT AND COMMISSION REGULATIONS** **JURY TRIAL DEMANDED**

I. INTRODUCTION

1. Since at least January 2014 through at least January 2016 (the "Relevant Period"), the company Gelfman Blueprint, Inc. ("GBI") and its Chief Executive Officer ("CEO") and Head Trader, Nicholas Gelfman ("Gelfman") (collectively, "Defendants"), operated a Bitcoin Ponzi scheme in which they fraudulently solicited participation in a pooled fund that purportedly employed a high-frequency, algorithmic trading strategy, executed by Defendants' computer program called "Jigsaw," to trade the virtual currency Bitcoin, a commodity in interstate commerce. During the Relevant Period, Defendants obtained more than approximately $600,000 from at least eighty customers ("GBI Customers") through these fraudulent solicitations. In fact, the strategy was fake, the purported performance reports were false, and—as in all Ponzi schemes—payouts of supposed profits to GBI Customers in actuality consisted of other customers' misappropriated funds.

2. Defendants fraudulently solicited potential GBI Customers by making false and misleading claims and omissions about the performance and reliability of Jigsaw. Then, once GBI Customers invested in the fraudulent scheme, Defendants attempted to conceal their fraudulent solicitations and misappropriation of funds through issuing false reports to GBI Customers. In this regard, Defendants prepared and conveyed to potential and actual GBI Customers numerous solicitation materials, asset and performance reports, and other materials (1) misrepresenting that GBI Customers averaged a 7-9% *monthly* increase in their Bitcoin balances net of all fees through Defendants' risk-protected strategy, when in fact they did not; (2) misrepresenting in individualized performance and balance reports that GBI Customers owned specific amounts of Bitcoin, when in fact those customers did not; and (3) misrepresenting that GBI's assets and performance were audited by a certified public accountant ("CPA"), when in fact they were not. In reality, the strategy was fake, the supposed trading results were illusory, and any payouts of supposed profits to investors in fact were derived from funds fraudulently obtained from other investors.

3. In an attempt to conceal the scheme, Gelfman staged a fake computer "hack" that supposedly caused the loss of nearly all GBI Customer funds. This was a lie. Later, again trying to conceal the full extent of the fraud, Gelfman claimed he had stolen only $25,000. But this too was a lie. In fact, Defendants misappropriated virtually all of the approximately $600,000 solicited from GBI Customers. As a result, GBI Customers have lost most if not all of their invested funds due to Defendants' fraud and misappropriation.

4. Through this conduct, Defendants were engaged, are engaging, or are about to engage in fraudulent acts and practices in violation of the Commodity Exchange Act ("Act"), 7 U.S.C. §§ 1–26 (2012), and Commission Regulations ("Regulations"), 17 C.F.R. pt. 1–190 (2017), specifically Section 6(c)(1) of the Act, 7 U.S.C. § 9(1) (2012), and Regulation 180.1(a), 17 C.F.R. § 180.1(a) (2017).

5. Accordingly, pursuant to Section 6c of the Act, as amended, 7 U.S.C. § 13a-1 (2012), the Commission brings this action to enjoin such acts and practices and compel compliance with the Act. In addition, the Commission seeks civil monetary penalties and remedial ancillary relief, including, but not limited to, trading bans, restitution, disgorgement, rescission, pre- and post-judgment interest, and such other relief as the Court may deem necessary and appropriate.

6. Unless restrained and enjoined by this Court, Defendants are likely to continue to engage in the acts and practices alleged in this Complaint and similar acts and practices, as more fully described below.

II. JURISDICTION AND VENUE

7. **Jurisdiction**. This Court has jurisdiction of this action pursuant to Section 6c of the Act, as amended, 7 U.S.C. § 13a-1, which authorizes the Commission to seek injunctive and other relief against any person whenever it shall appear to the Commission that such person has engaged, is engaging, or is about to engage in any act or practice constituting a violation of any provision of the Act or any rule, regulation, or order thereunder.

8. **Venue**. Venue properly lies with the Court pursuant to Section 6c(e) of the Act, 7 U.S.C. § 13a-1(e), because Defendants are found in, inhabit, or transact business in this District, and because acts and practices in violation of the Act occurred, are occurring, or are about to occur, within this District.

III. THE PARTIES

9. Plaintiff **Commodity Futures Trading Commission** ("Commission" or "CFTC") is an independent federal regulatory agency that is charged by Congress with the administration and enforcement of the Act and the Regulations. The Commission maintains its principal office at Three Lafayette Centre, 1155 21st Street, N.W. Washington, D.C. 20581.

10. Defendant **Gelfman Blueprint, Inc.** is a New York corporation based in Staten Island, New York. GBI was incorporated on August 7, 2014. GBI's last known address is 533 Wilson Avenue, Staten Island, NY 10312. GBI has never been registered with the Commission.

11. Defendant **Nicholas Gelfman** is a resident of Brooklyn, New York. Gelfman was the CEO and Head Trader of GBI. Gelfman has never been registered with the Commission.

IV. STATUTORY BACKGROUND

12. Bitcoin and other virtual currencies are encompassed in the definition of "commodity" under Section 1a(9) of the Act, 7 U.S.C. § 1a(9) (2012).[1]

V. FACTS

13. During the Relevant Period, Defendants solicited and received more than approximately $600,000 from at least eighty GBI Customers, who invested amounts ranging from a few hundred dollars to tens of thousands of dollars, for the purpose of entering into contracts of sale of Bitcoin, a virtual currency, through electronic web-based Bitcoin trading platforms based in various states and countries.

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[1] For purposes of this Complaint, a virtual currency means a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value, but does not have legal tender status in any jurisdiction. Bitcoin and other virtual currencies are distinct from "real" currencies, which are the coin and paper money of the United States or another country that are designated as legal tender, circulate, and are customarily used and accepted as a medium of exchange in the country of issuance.

Defendants Made False and Misleading Representations, and Omitted Material Facts, to Solicit GBI Customers

14. During the Relevant Period, Defendants solicited customers in Manhattan, Staten Island, and elsewhere to invest in GBI's fund.

15. Gelfman solicited customers, and received and directed deposits, withdrawals, and transfers of GBI Customer funds on behalf of GBI.

16. Defendants' solicitations to potential GBI Customers to participate in GBI's pooled fund included false and misleading representations and omissions of material facts—in short, lies and deceit—about the profitability and safety of investing in GBI.

17. Defendants made these false and misleading representations and omissions of material facts to potential customers during the Relevant Period through the GBI website.

18. For example, during the Relevant Period, GBI's website touted the high investment performance of Defendants' high-frequency, algorithmic trading computer program (or "bot") named Jigsaw. In particular, GBI's website claimed that GBI's Jigsaw trading strategy both generated monthly profits and protected against risk (such as the volatility of Bitcoin prices, and the risk that the value of Bitcoin could drop) for customers invested in the fund, with statements such as:

> INCREASED BITCOIN BALANCE Customers average a 7-9% monthly increase in ฿. [฿ is a symbol used for Bitcoin]
>
> PROTECTING AGAINST VOLATILITY Trading results are maximized during price drops.

19. These statements were false and misleading representations and omissions of material facts. In fact, GBI Customers did not average the 7-9% monthly increase in Bitcoin, and in reality the purported strategy did not "maximize" trading results—i.e., achieve even higher than 7-9% monthly returns—during price drops.

20. During the Relevant Period, Defendants' primary Bitcoin trading account for its supposed Jigsaw trading strategy was at an international virtual currency exchange, under the name of TMJigsaw ("Defendants' Jigsaw trading account").

21. The account records of Defendants' Jigsaw trading account reveal only infrequent and unprofitable trading. In particular, during 2015, Defendants' Jigsaw trading account records reveal trading on only 17 calendar days that incurred approximately 185 Bitcoin in losses.

22. Gelfman exclusively controlled and had access to Defendants' Jigsaw trading account.

23. During the Relevant Period, GBI's website also touted GBI Customers' access to their current balances, deposits, and withdrawals though the GBI website's "interactive customer dashboard."

24. These statements constituted false and misleading representations and omissions of material facts. In fact, GBI Customers could not access their true current balances, deposits, and withdrawals through the website's "interactive customer dashboard." As described below, the figures reflecting large gains provided through the dashboard were false.

25. During the Relevant Period, these pages on GBI's website touting GBI's high investment performance, strategy, and account transparency were publicly available.

26. Defendants also made false and misleading representations and omissions of material facts to potential customers during the Relevant Period through GBI marketing materials.

27. For example, Defendants' marketing materials used for soliciting customers touted the high investment performance of Jigsaw through statements such as the following:

- Our fund earns customers a 7-11% monthly return on their bitcoins.

- Our customers on average are and have been averaging 7-9% profit a month on their Bitcoin Investments.
- As of August 1st, 2015 we had 85 customers, 2,367 bitcoins under management and 717 in revenue.

28. Using the then-prevailing exchange rate, 2,367 Bitcoin was equivalent to approximately $660,000, and 717 Bitcoin was equivalent to approximately $200,000.

29. These and similar statements about Defendants' trading performance and Bitcoin under management were false and misleading representations and omissions of material facts.

30. In fact, as stated above, Defendants' Jigsaw trading account records reveal only infrequent trading that resulted in trading losses.

31. In fact, Defendants' Bitcoin under management was far, far less. Defendants' Jigsaw trading account records show a Bitcoin balance of less than 270 Bitcoin as of early July 2015 (equivalent to approximately $73,000 using the then-prevailing exchange rate), no Bitcoin trading activity at all after early July 2015, and a Bitcoin balance of zero beginning in early August 2015.

32. Defendants also made false and misleading representations and omissions of material facts to potential customers during the Relevant Period through various internet social media websites, such as Instagram and Facebook, with statements such as:

> We are a software development firm, currently offering customers access to a high frequency BTC [Bitcoin] trading program called "Jigsaw" (2% weekly BTC [Bitcoin] return).

33. These and similar statements that Jigsaw offered a 2% weekly Bitcoin return were false and misleading representations and omissions of material facts. In reality, as stated above, Defendants' Jigsaw trading account records reveal only infrequent trading and substantial Bitcoin losses.

34. During the Relevant Period, these social media solicitations touting GBI's high investment performance, strategy, and account transparency were publicly available.

35. Defendants also made false and misleading representations and omissions of material facts to potential customers during the Relevant Period through internet chat room posts, with statements such as:

> The current return is advertised at 7-9% monthly over an extended time period, and is based on the return you receive after we take our commission.

36. These and similar statements that Defendants provided customers with a 7-9% monthly return, after commission, over an extended time period, were false and misleading representations and omissions of material facts. In reality, as stated above, Defendants' Jigsaw trading account records reveal only infrequent trading and substantial Bitcoin losses.

37. During the Relevant Period, such internet chat room solicitations touting GBI's high investment performance and strategy were publicly available.

38. Defendants also made false and misleading representations and omissions of material facts to potential customers during the Relevant Period in person.

39. Typically, these false and misleading representations and omissions concerned GBI's net monthly returns, the safety of investments with GBI (such as the claim that Jigsaw consistently generated profits regardless of whether Bitcoin prices went up or down), and GBI Customers' ability to monitor their investments online through the GBI website.

40. For example, in or around December 2014, in Manhattan, Gelfman and another GBI officer made such false and misleading statements about GBI's performance, the safety of the investment, and GBI Customers' ability to monitor their investments, while soliciting a potential customer in person. This person then became a GBI Customer, over time investing more than $50,000, all of which was misappropriated by Defendants.

41. Similarly, in or around April 2015, in Brooklyn, agents of GBI using information provided by Gelfman made such false and misleading statements about GBI's performance, the safety of the investment, and GBI Customers' ability to monitor their investments, while soliciting a potential customer in person. This person then became a GBI Customer, over time investing more than $60,000, all of which was misappropriated by Defendants.

42. Similarly, in or around June 2015, in Staten Island, agents of GBI using information provided by Gelfman made such false and misleading statements about GBI's performance, the safety of the investment, and GBI Customers' ability to monitor their investments, while soliciting a potential customer in person. This person then became a GBI Customer, over time investing more than $40,000, all of which was misappropriated by Defendants.

43. Such statements in person by Defendants to these and numerous other potential customers were false and misleading representations and omissions of material facts. In reality, as stated above, Defendants' Jigsaw trading account records reveal only infrequent trading that resulted in substantial Bitcoin losses, and GBI Customers could not verify and monitor their investments online, such as through logging into GBI website's customer "dashboard," since the information Defendants provided therein was falsified by Defendants.

44. Defendants made these false and misleading representations and omissions of material facts to potential customers as well as existing GBI Customers on the GBI website, in marketing materials, in internet social media and chatroom websites, and in person knowingly or with reckless disregard for the truth.

<u>Defendants Provided False Account Statements and Made Other Misrepresentations to GBI Customers</u>

45. Defendants were fiduciaries of GBI Customers.

46. Despite this, during the Relevant Period Defendants perpetuated their fraudulent scheme by providing GBI Customers false reports, by obtaining false and misleading documents from an accountant through deceit, and through other false and misleading representations and omissions of material facts.

47. Once GBI Customers had invested in GBI, Defendants provided GBI Customers with password-protected access to restricted areas of Defendants' website where GBI Customers could access and view account statements and reports purporting to show their account balances and trading profits or losses.

48. During the Relevant Period, these statements and reports to GBI Customers were false and misleading because the reported trading conducted on behalf of customers did not occur. In reality, the account and performance statements misrepresented, and provided false and misleading descriptions of, trading activity and account balances.

49. For example, on or around August 1, 2015, one GBI Customer logged into the GBI website and received from the GBI "dashboard" an account statement that the customer's investment balance was 197.719 Bitcoin, worth $58,297.45 (purportedly using the then-prevailing exchange rate). This reported balance reflected customer profits (net of fees to GBI and a subsequent deposit) of more than 38%, achieved in less than two months, based on the customer's initial investment of approximately $40,000.

50. In fact, this statement and report to the GBI Customer were false and misleading. The reported balance did not exist, and the reported profits were illusory. During that two-month period, Defendants' Jigsaw trading account records reveal trading on only four calendar days that resulted in thousands of dollars in losses.

51. During the Relevant Period, Defendants also provided account balance and profitability information by telephone to GBI Customers.

52. The GBI Customer account balance and profitability information provided by Defendants to GBI Customers by telephone was false and misleading because the supposed trading conducted on behalf of investors did not occur, the balances did not exist, and the reported profits were illusory. In reality, as stated above, Defendants' Jigsaw trading account records reveal only infrequent trading and substantial Bitcoin losses.

53. In or around July to October 2015, Defendants obtained a series of one-page documents from an accountant stating GBI's assets under management, specifically, the amount of GBI's balance at a particular Bitcoin exchange as of a particular date.

54. These documents obtained from the accountant reflected that GBI's assets under management held at the specific exchange, an international platform advertised as the "world's largest and most advanced cryptocurrencies exchange," were increasing in value each month and, as of October 2015, were in excess of $840,000.

55. These statements were false and misleading representations and omissions of material facts.

56. In reality, Defendants' account balance was far, far less: Defendants' Jigsaw trading account records show a Bitcoin balance of less than 270 Bitcoin as of early July 2015 (then equivalent to approximately $73,000), and a Bitcoin balance of zero beginning in early August 2015.

57. Defendants fraudulently obtained the one-page account-balance documents from the accountant by providing the accountant with information Defendants knew to be misleading and false, such as false account or balance statements that Gelfman had generated with the intent to deceive.

58. Referring to this accountant and these documents, Defendants represented to potential and actual GBI Customers that GBI had monthly CPA audited results and asserted balances under management according to the last CPA audit.

59. These statements were false and misleading representations and omissions of material facts.

60. In reality, this accountant was not a CPA.

61. In reality, this accountant never performed an audit of GBI.

62. In reality, the account balance documents stated false balances because the information that Defendants provided to the accountant was false and intended to mislead.

63. Defendants made these and other false and misleading representations and omissions of material facts to potential and actual GBI Customers concerning trading activity and results, account balances, and CPA audits knowingly or with reckless disregard for the truth.

<u>Defendants Misappropriated GBI Customers' Funds</u>

64. Between approximately January 2014 and December 2015, Defendants received in excess of approximately $600,000 from more than 80 GBI Customers.

65. During the Relevant Period, Defendants misappropriated almost all of these GBI Customers' funds for improper and unauthorized uses, such as to pay GBI business expenses and to wrongfully enrich Gelfman.

66. For example, during the Relevant Period, GBI charged GBI Customers fees in the form of large percentages of supposed Bitcoin trading profits.

67. Nearly all GBI Customers were charged fees of approximately 50- 65% of those purported trading profits.

68. Defendants' representations of trading results and profits for or on behalf of GBI Customers were false. Consequently, all "fees" deducted by Defendants from GBI Customers' funds based on these false profits in fact were GBI Customer funds that Defendants misappropriated from GBI Customers.

69. In or around October 2015, Gelfman told other GBI officers that a computer "hack" had caused GBI to lose all or nearly all of GBI Customers' investments. Defendants then conveyed this story to GBI Customers to explain the loss of their investments.

70. For instance, Defendants notified a GBI Customer, who had invested more than $50,000 beginning in December 2014, and whose investment in GBI's fund had purportedly generated tens of thousands of dollars of profits through Jigsaw, of the supposed hack and that all of the GBI Customer's investments were gone. This GBI Customer was never repaid any of the investment.

71. In fact, Defendants' statements about the supposed computer "hack" causing the loss of all or nearly all GBI's Bitcoin were false.

72. In fact, there was no "hack" in October 2015 causing massive losses. In fact, Defendants' Jigsaw trading account records reveal that the account had had a Bitcoin balance of zero since early August 2015.

73. In fact, Defendants had misappropriated nearly all of the GBI Customers' funds for Defendants' own financial benefit and to transfer the funds illegally to other customers of the Ponzi scheme, and had invented the falsehood of the "hack" to conceal this misappropriation.

74. To the extent any GBI Customers received any purported profits from GBI, those profits in fact consisted of funds that Defendants misappropriated from other GBI Customers, in the nature of a Ponzi scheme.

75. In or around January 2016, Gelfman confessed to other GBI officers, such as the Chief Operating Officer and the Chief Compliance Officer, that he had stolen approximately $25,000 from GBI.

76. In fact, Gelfman had misappropriated far in excess of $25,000 in GBI Customer funds. In reality, Defendants misappropriated nearly all GBI Customer funds.

Nicholas Gelfman's Invocation of Fifth Amendment Privilege Against Self-Incrimination

77. On April 22, 2016, pursuant to an investigatory subpoena, Gelfman appeared before the Commission for testimony concerning GBI.

78. In response to Division staff's questions at this testimony, Gelfman invoked his Fifth Amendment privilege against compelled self-incrimination.

Gelfman Was a Controlling Person of GBI

79. Defendants' website and marketing materials identified Gelfman as CEO and Head Trader of GBI. Gelfman solicited investors on behalf of GBI, created and controlled the performance and investment information in solicitation materials, created and controlled the content of GBI's website, oversaw and controlled GBI's trading of Bitcoin, was a signatory to GBI bank accounts, and generated account information on behalf of GBI.

Gelfman Acted as Agent for GBI

80. Through his actions as CEO and head trader overseeing Bitcoin trading by GBI, managing the purported Jigsaw bot, and calculating GBI purported performance results, and thus profits and fees, as well as through his additional actions of marketing GBI to potential investors, soliciting investors, providing information to the accountant during reviews of GBI's assets under management, and providing account information to GBI Customers, Gelfman acted in the scope of his employment and on behalf of GBI.

VI. VIOLATIONS OF THE COMMODITY EXCHANGE ACT AND REGULATIONS

Count I—Fraud by Deceptive Device or Contrivance

Violations of Section 6(c)(1) of the Act and Regulation 180.1(a) by Gelfman and GBI

81. Paragraphs 1 through 80 are re-alleged and incorporated herein by reference.

82. Section 6(c)(1) of the Act, 7 U.S.C. § 9(1) (2012), makes it unlawful for any person, directly or indirectly, to:

> use or employ, or attempt to use or employ, in connection with any swap, or a contract of sale of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity, any manipulative or deceptive device or contrivance, in contravention of such rules and regulations as the Commission shall promulgate by not later than 1 year after [July 21, 2010, the date of enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act] . . . .

83. Regulation 180.1(a), 17 C.F.R. § 180.1(a) (2017), provides:

> It shall be unlawful for any person, directly or indirectly, in connection with any swap, or contract of sale of any commodity in interstate commerce, or contract for future delivery on or subject to the rules of any registered entity, to intentionally or recklessly:
>
> (1) Use or employ, or attempt to use or employ, any manipulative device, scheme, or artifice to defraud;

> (2) Make, or attempt to make, any untrue or misleading statement of a material fact or to omit to state a material fact necessary in order to make the statements made not untrue or misleading;
>
> (3) Engage, or attempt to engage, in any act, practice, or course of business, which operates or would operate as a fraud or deceit upon any person . . . .

84. During the Relevant Period, as described above, Defendants violated Section 6(c)(1) of the Act and Regulation 180.1(a) by, among other things, in connection with contracts of sale of commodities in interstate commerce, making or attempting to make untrue or misleading statements of material fact or omitting to state or attempting to omit material facts necessary in order to make statements made not untrue or misleading, such as the following:

A. Issuing performance statements and updates misrepresenting the supposed amount of bitcoins and profits in GBI Customers' purported accounts;

B. Issuing written statements misrepresenting the amount of GBI's assets under management;

C. Issuing written statements misrepresenting the profitability of Defendants' Bitcoin trading;

D. Failing to disclose, and omitting, that GBI never achieved the advertised performance and returns—such as a 7-9% monthly increase in bitcoins—for its customers;

E. Failing to disclose, and omitting, that GBI never was audited by a CPA; and

F. Failing to disclose, and omitting, that Defendants were misappropriating GBI Customer funds.

85. As described above, Defendants violated Section 6(c)(1) of the Act and Regulation 180.1(a) by, among other things, in connection with contracts of sale of a commodity in interstate commerce, soliciting investors with false and misleading performance statements; providing GBI Customers false account and performance statements that misrepresented GBI Customers' investment performance; misrepresenting and omitting material facts on Defendants' website and in other communications with investors regarding GBI's strategy, performance, and

CPA audits, as well as other material facts regarding GBI and GBI Customers' interest in the fund; and misappropriating GBI Customers' funds.

86. Defendants engaged in the acts and practices described above willfully, intentionally, or recklessly.

87. By this conduct, Defendants violated Section 6(c)(1) of the Act and Regulation 180.1(a).

88. The acts, omissions, and failures of Gelfman described in this Complaint occurred within the scope of his agency, employment, and office at GBI. Accordingly, GBI is liable under Section 2(a)(1)(B) of the Act, 7 U.S.C. § 2(a)(1)(B) (2012), and Regulation 1.2, 17 C.F.R. § 1.2 (2017), as principal for its agent's acts, omissions, or failures in violation of the Section 6(c)(1) of the Act and Regulation 180.1(a).

89. At all times relevant to this Complaint, Gelfman controlled GBI, directly or indirectly, and did not act in good faith or knowingly induced, directly or indirectly, GBI's conduct constituting the violations of GBI described in this Count. Accordingly, pursuant to Section 13(b) of the Act, 7 U.S.C. § 13c(b) (2012), Gelfman is liable for GBI's violations of Section 6(c)(1) of the Act and Regulation 180.1(a).

90. Each act of (1) using or employing, or attempting to use or employ, a manipulative device, scheme, or artifice to defraud; (2) making, or attempting to make, untrue or misleading statements of material fact, or omitting to state material facts necessary to make the statements not untrue or misleading; and (3) engaging, or attempting to engage, in a fraudulent or deceitful act, practice, or a course of business, including but not limited to those specifically alleged herein, is alleged as a separate and distinct violation of Section 6(c)(1) of the Act and Regulation 180.1.

VII. RELIEF REQUESTED

WHEREFORE, the Commission respectfully requests that the Court, as authorized by Section 6c of the Act, 7 U.S.C. § 13a-1 (2012), and pursuant to its own equitable powers, enter:

A. An order finding that Defendants violated Section 6(c)(1) of the Act, 7 U.S.C. § 9(1) (2012), and Regulation 180.1(a), 17 C.F.R. § 180.1(a) (2017);

B. An order of permanent injunction enjoining each Defendant and any other person or entity associated with them, including but not limited to affiliates, agents, servants, employees, assigns, attorneys, and all persons in active concert or participation with any Defendant, including any successor thereof, from:

i. Engaging, directly or indirectly, in conduct in violation of Section 6(c)(1) of the Act, or Regulation 180.1(a);

ii. Trading on or subject to the rules of any registered entity (as that term is defined in Section 1a(40) of the Act, 7 U.S.C. § 1a(40) (2012));

iii. Entering into any transactions involving "commodity interests" (as that term is defined in Regulation 1.3(yy), 17 C.F.R. § 1.3(yy) (2017)), for their own personal account(s) or for any account in which Defendants have a direct or indirect interest;

iv. Having any commodity interests traded on Defendants' behalf;

v. Controlling or directing the trading for or on behalf of any other person or entity, whether by power of attorney or otherwise, in any account involving commodity interests; and/or

vi. Soliciting, receiving, or accepting any funds from any person for the purpose of purchasing or selling any commodity interests;

C. An order requiring Defendants to pay civil monetary penalties, plus post-judgment interest thereon, in the amount of the greater of (1) $170,472 for each violation of the Act and Regulations, or (2) triple the monetary gain from violations of the Act and Regulations;

D. An order directing Defendants, as well as any successors thereof, to disgorge, pursuant to such procedure as the Court may order, all benefits received including, but not limited to, trading profits, revenues, salaries, commissions, fees, or loans derived directly or indirectly from acts or practices which constitute violations of the Act and Regulations, as described herein, and pre- and post-judgment interest thereon from the date of such violations;

E. An order directing Defendants, as well as any successors thereof, to make full restitution, pursuant to such procedure as the Court may order, to every customer and investor whose funds any Defendant received, or caused another person or entity to receive, as a result of the acts and practices constituting violations of the Act and Regulations, as described herein, and pre- and post-judgment interest thereon from the date of such violations;

F. An order directing Defendants, as well as any successors thereof, to rescind, pursuant to such procedure as the Court may order, all contracts and agreements, whether express or implied, entered into between, with, or among Defendants and any customer or investor whose funds were received by Defendants as a result of the acts and practices which constituted violations of the Act and the Regulations, as described herein;

G. An order directing that Defendants, and any successors thereof, make an accounting to the Court of all of their assets and liabilities, together with all funds they received from and paid to investors and other persons in connection with commodity transactions and all disbursements for any purpose whatsoever of funds received from commodity transactions, including salaries, commissions, interest, fees, loans, and other disbursement of money or property of any kind from at least January 2014 to the date of such accounting;

H. An order requiring Defendants and any successors thereof to pay costs and fees as permitted by 28 U.S.C. §§ 1920 and 2412(a)(2) (2012); and

I. An order providing such other and further relief as the Court deems proper.

* * *

VIII. DEMAND FOR JURY TRIAL

Plaintiff hereby demands a jury trial.

Dated: September 21, 2017

COMMODITY FUTURES TRADING COMMISSION

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COMMODITY FUTURES TRADING COMMISSION

Commodity Futures Trading Comm'n v. McDonnell

Decided Mar 6, 2018

18-CV-361

03-06-2018

COMMODITY FUTURES TRADING COMMISSION, Plaintiff, v. PATRICK K. MCDONNELL, and CABBAGETECH, CORP. d/b/a COIN DROP MARKETS, Defendants.

Appearances Commodity Futures Trading Commission David William Oakland Commodity Futures Trading Commission 140 Broadway, 19th Floor New York, NY 10005 Email: doakland@cftc.gov Kenneth B. Tomer Commodity Futures Trading Commission 140 Broadway 19th Floor New York, NY 10005 Email: ktomer@cftc.gov Gates Salyers Hurand Commodity Futures Trading Commission 140 Broadway, 19th Floor Ny, NY 10005 646-746-9700 Fax: 646-746-3903 Email: ghurand@cftc.gov Patrick McDonnell CabbageTech Corp., d/b/a/ Coin Drop Markets Pro se

JACK B. WEINSTEIN, Senior United States District Judge

MEMORANDUM & ORDER

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2

*2 **JACK B. WEINSTEIN, Senior United States District Judge :**

Table of Contents

 *3 I. Introduction

The Commodity Futures Trading Commission ("CFTC") sues Patrick McDonnell and his company Coin Drop Markets. CFTC alleges defendants "operated a deceptive and fraudulent virtual currency scheme . . . for purported virtual currency trading advice" and "for virtual currency purchases and trading . . . and simply misappropriated [investor] funds." *See* CFTC Complaint, ECF No. 1, Jan. 18, 2018, at 1 ("CFTC Compl.").

CFTC seeks injunctive relief, monetary penalties, and restitution of funds received in violation of the Commodity Exchange Act ("CEA"). *Id.* at 11.

Until Congress clarifies the matter, the CFTC has concurrent authority, along with other state and federal administrative agencies, and civil and criminal courts, over dealings in virtual currency. An important nationally and internationally traded commodity, virtual currency is tendered for payment for debts, although, unlike United States currency, it is not legal tender that must be accepted. Title 31 U.S.C. § 5103 ("United States coins and currency . . . are legal tender for all debts . . .").

A. Commodity Futures Trading Commission ("CFTC") Standing

The primary issue raised at the outset of this litigation is whether CFTC has standing to sue defendants on the theory that they have violated the CEA. Title 7 U.S.C. § 1. Presented are two questions that determine the plaintiff's standing: (1) whether virtual currency may be regulated by the CFTC as a commodity; and (2) whether the amendments to the CEA under the Dodd-Frank Act permit the CFTC to exercise its jurisdiction over fraud that does not directly involve the sale of futures or derivative contracts.

Both questions are answered in the affirmative. A "commodity" encompasses virtual currency both in economic function and in the language of the
4 statute. Title 7 U.S.C. § 1(a)(9) *4 (The CEA defines "commodity" as agricultural products and "all other goods and articles . . . and all services, rights, and interests . . . in which contracts for future delivery are presently or in the future dealt in.").

CFTC's broad authority extends to fraud or manipulation in derivatives markets and underlying spot markets. *See* Title 7 U.S.C. § 9(1). CFTC may exercise its enforcement power over fraud related to virtual currencies sold in interstate commerce. *See* Title 17 C.F.R. § 180.1.

B. Injunctive Relief

After hearing testimony from an Investigator in the Division of Enforcement for the CFTC, the court finds the plaintiff has made a preliminary prima facie showing that the defendants committed fraud by misappropriation of investors' funds and misrepresentation through false trading advice and promised future profits.

A preliminary injunction is granted in favor of the CFTC. The court finds a reasonable likelihood that without an injunction the defendants will continue to violate the CEA. An order outlining the terms of relief is issued and attached. *See* Appendix A, Order of Preliminary Injunction and Other Relief ("App. A, Prelim. Injunction"). II. Facts

Patrick McDonnell and his company CabbageTech, Corp., doing business as Coin Drop Markets ("defendants"), offered fraudulent trading and investment services related to virtual currency, *see* Description of "Virtual Currencies" *infra* Part III, in the spring and summer of 2017. Christopher Giglio Declaration, ECF No. 21, Feb. 26, 2018, Ex. 2 ("Giglio Decl.") ¶¶ 13,14.

Customers from the United States and abroad paid defendants for "membership" in virtual currency trading groups purported to provide exit prices and
5 profits of up to "300%" per *5 week. *Id*. ¶¶ 17-20. Defendants advertised their services through "at least two websites, www.coindropmarkets.com and www.coindrops.club," as well as on the social media platform Twitter. *Id*. ¶¶ 15-17.

"Investors" transferred virtual currency to the defendants for "day" trading. *Id*. ¶ 21 ("McDonnell claimed that he could generate profits of 2 to 300% each day for [an] Investor . . . and that $1,000 in Litecoin [a type of virtual currency] should be earning $200 to $250 per day through trading.").

After receiving membership payment or virtual currency investments, defendants deleted their "social media accounts" and "websites and ceased communicating with . . . customers around July, 2017." *Id*. ¶ 26. Defendants provided minimal, if any, virtual currency trading advice and never achieved the promised return on investment. *Id*. ¶ 27. When customers asked for a return of their membership fee, or virtual currency investment, the defendants refused and misappropriated the funds. *Id*. ¶¶ 27-32. III. Background of Bitcoin and Virtual Currencies

A. Description of Virtual Currencies

Virtual currencies are generally defined as "digital assets used as a medium of exchange." Skadden's Insights, *Bitcoins and Blockchain: The CFTC Takes Notice of Virtual Currencies*, Jan., 2016. They are stored electronically in "digital wallets," and exchanged over the internet through a direct peer-to-peer system. *Id*. They are often described as "cryptocurrencies" because they use "cryptographic protocols to secure transactions . . . recorded on publicly available decentralized ledgers," called "blockchains." Brief of CFTC In Support of Preliminary Injunction and Other Relief, ECF No. 21, Feb. 26, 2018, at 4 ("CFTC
6 Brief"). *6

The "blockchain" serves as a digital signature to verify the exchange. *See* Appendix B, *A CFTC Primer on Virtual Currencies*, Oct. 17, 2017, at 5 ("App. B, *CFTC Primer*"). "The public nature of the decentralized ledger allows people to recognize the transfer of virtual currency from one user to another without requiring any central intermediary in which both users need to trust." CFTC Brief, at 4. Some experts believe blockchain technology underlying virtual currencies will serve to "enhance [future] economic efficiency" and have a "broad and lasting impact on global financial markets in payments, banking, securities settlement, title recording, cyber security and trade reporting and analysis." Appendix C, United States Senate Banking Committee, *Hearing on Virtual Currency*, Feb. 6, 2018 (written testimony of Christopher Giancarlo, Chairman, CFTC) ("App. C, CFTC Chair, Congressional Testimony"). Virtual currencies are not backed by any government, fiat currency, or commodity. Robert J. Anello, *New-Wave Legal Challenges for Bitcoin and Other CryptoCurrencies*, Law Journal Newsletters, Nov. 2017.

They have some characteristics of government paper currency, commodities, and securities. Allison Nathan, *Interview with Eric Posner*, Goldman Sachs Global Investment Research, Mar. 11, 2014 ("It is a lot like gold, in fact. The difference [] is that it is digital rather than a heavy, unwieldy object. That means that it could serve the same purposes as gold in terms of a currency, but much more efficiently because it does not have any mass and can be sent easily from place to place."); *cf. Power of the Executive to Change the*

Gold Value of the Dollar, Columbia Law Review, Vol. 48, No. 3 (Apr. 1948) ("[T]he United States is committed to a policy of international cooperation, and in particular, to a program of international stability of [currency] exchange rates . . .").

7 B. Expansion and Value *7

The price of Bitcoin, and other virtual currencies, has risen, and then fallen, at extreme rates. Olga Kharif, *All you Need to Know About Bitcoin's Rise*, *From $0.01 to $15,000*, Bloomberg Businessweek, Dec. 1, 2017 ("The initial price of bitcoin, set in 2010, was less than 1 cent. Now it's crossed $16,000. Once seen as the province of nerds, libertarians and drug dealers, bitcoin today is drawing millions of dollars from hedge funds.").

As their value has increased, online exchanges have become more accessible allowing more members of the public to trade and invest in virtual currencies.

> While there are many Bitcoin exchanges around the world, Coinbase has been the dominant place that ordinary Americans go to buy and sell virtual currency. No company had made it simpler to sign up, link a bank account or debit card, and begin buying Bitcoin.
>
> The number of people with Coinbase accounts has gone from 5.5 million in January [2017] to 13.3 million at the end of November, according to data from the Altana Digital Currency Fund. In late November, Coinbase was sometimes getting 100,000 new customers a day — leaving the company with more customers than Charles Schwab and E-Trade.

Nathaniel Popper, *Coinbase: The Heart of the Bitcoin Frenzy*, N.Y. Times, Dec. 6, 2017; Ian Parker, *A Bitcoin A.T.M. Comes To A New York Deli*, New Yorker, Sept. 18, 2017 ("A Coinsource A.T.M. accepts dollars and in return adds the bitcoin equivalent (less Coinsource's seven per cent) to a customer's digital wallet.").

According to coinmarketcap.com (viewed Feb. 6, 2018, at approximately 9:10 a.m. EST), there were over 1500 virtual currencies. Bitcoin had the largest market capitalization, valued at $121,264,863,386. *Id*. A single Bitcoin was valued at $7,196.92. *Id*. The cheapest virtual currency, Strong Hands, was valued at $0.000001. *Id*.

The combined market capitalization of all virtual currencies as of January 6, 2018, was roughly $795 billion; by Feb. 6, 2018, the total value had dropped to $329 billion. Coin Market Cap, https://coinmarketcap.com/charts/ (last visited
8 Feb. 6, 2018); Arjun Kharpal, *Over $60* *8 *Billion Wiped off Value of Cryptocurrencies as Bitcoin Drops Below $8,000 again*, CNBC, Feb. 5, 2018 ("It was not only bitcoin that fell either. Other major virtual currencies, including ethereum and ripple, fell sharply in the last 24 hours.").

C. Fraud and Crime

The rise in users and value of virtual currencies has been accompanied by increased fraud and criminal activity. Edgar G. Sánchez, *Crypto-Currencies: The 21st Century's Money Laundering and Tax Havens*, 28 U. Fla. J.L. & Pub. Pol'y 167, 169 (2017) ("[T]he newest growing concern with Bitcoin, and crypto-currencies in general, are their ability to wash money and conceal taxable income.").

Silk Road, an online drug market that allowed for purchase through Bitcoin, was one of the earliest and most audacious examples of crime enabled by virtual currencies.

> The largest case involving Bitcoin and illegal activity was the Silk Road case, which included billions of dollars in black market drug sales, two federal agents caught (and convicted for) stealing, and murder-for-hire attempts. While the U.S. government claimed a victory in curbing illegal activity facilitated with Bitcoin by shutting down the Silk Road's massive black market for drugs, Bitcoin is still available, and other online black markets have tripled the industry since Silk Road's closure.

Christopher Burks, *Bitcoin: Breaking Bad or Breaking Barriers?*, 18 N.C.J.L. & Tech. On. 244, 251-52 (2017) (internal citations omitted); *see also* U.S. Attorney's Office EDNY, *Long Island Woman Indicted for Bank Fraud and Money Laundering to Support Terrorists*, Dec. 14, 2017 (The defendant allegedly "laundered and transferred the funds [using virtual currencies] out of the country to support the Islamic State . . .").

Virtual currency exchanges have been victims of hacking and theft. Reuters Staff, *The Coincheck Hack and the Issue With Crypto Assets on Centralized Exchanges*, Jan. 29, 2018 ("Hackers have stolen roughly 58 billion yen ($532.6
9 million) from Tokyo-based cryptocurrency *9
exchange Coincheck Inc, raising questions about security and regulatory protection in the emerging market of digital assets."); Alex Hern, *A History of Bitcoin Hacks*, The Guardian, Mar. 18, 2014 ("25,000 bitcoins were stolen from their wallet after hackers compromised the Windows computer they were using. Even at the time, that sum was worth more than $500,000; it would now be worth a little less than £10m.").

These and other criminal acts have led some to call for increased governmental oversight and regulation of virtual currency.

> Having delved into the prevalence of money laundering and tax evasion both globally and in the United States, and the rise of crypto-currencies and their use in disguising real money, the question remains as to what steps can be taken to legitimize crypto-currencies, or at the very least, put an end to their use for illegal purposes.

Sánchez, *supra* at 188.

D. Regulation and Oversight of Virtual Currency

Congress has yet to authorize a system to regulate virtual currency. T. Gorman, *Blockchain*, *Virtual Currencies and the Regulators*, Dorsey & Whitney LLP, Jan. 11, 2018 ("As the CFTC recently admitted, U.S. law does not provide for 'direct comprehensive U.S. regulation of virtual currencies. To the contrary a multi-regulatory approach is being used.'").

The CFTC, and other agencies, claim concurrent regulatory power over virtual currency in certain settings, but concede their jurisdiction is incomplete. *See* App. C, CFTC Chair, Congressional Testimony ("[C]urrent law does not provide any U.S. Federal regulator with such regulatory oversight authority over spot virtual currency platforms [not involving fraud] operating in the United States or abroad."); *cf.* Doris Kearns Goodwin, *The Bully Pulpit*, (2013) at 443 ("Roosevelt . . . continued to regard the judicial system as an ineffective arena for controlling giant corporations . . . Regulation, he believed,
10 promised a far better remedy. 'The *10 design
should be to prevent the abuses incident to the creation of unhealthy and improper combinations [] instead of waiting until they are in existence and then attempting to destroy them by civil or criminal proceedings.'"); *cf.* Balleisen, Bennear, Kraweic, and Weiner, *Policy Shock*, (2017) at 543-44 ("[T]ypes of regulatory responses to a crisis may vary along many dimensions. These

responses may be robust or cosmetic. They may be structural (reorganizing government or instrumental (changing policy tools).").

1. Potential Virtual Currency Regulation

Until Congress acts to regulate virtual currency the following alternatives appear to be available:

1. No regulation. *See*, *e.g*., Nikolei M. Kaplanov, *Nerdy Money: Bitcoin, the Private Digital Currency, and the Case Against Its Regulation*, 25 Loy. Consumer L. Rev. 111, 113 (2012) ("This Comment will show that the federal government has no legal basis to prohibit bitcoin users from engaging in traditional consumer purchases and transfers. This Comment further argues that the federal government should refrain from passing any laws or regulations limiting the use of bitcoins . . . applying any sort of regulation to bitcoin use, [] would be ineffective and contrary to the interest of the United States consumers.").

2. Partial regulation through criminal law prosecutions of Ponzi-like schemes by the Department of Justice, or state criminal agencies, or civil substantive suits based on allegations of fraud. *See*, *e.g*., *United States v. Faiella*, 39 F. Supp. 3d 544, 545 (S.D.N.Y. 2014) ("Defendants in this case are charged in connection with their operation of an underground market in the virtual currency 'Bitcoin' via the website 'Silk Road.'"); *United States v. Lord*, No. CR 15-00240-01/02, 2017 WL 1424806, at *2 (W.D. La. Apr.

11 *11

20, 2017) ("Counts 2-14 charged Defendants with various other crimes associated with operating their bitcoin exchange business.").

3. Regulation by the Commodity Futures Trading Commission ("CFTC"). *See infra* Part III.D.2.

4. Regulation by the Securities and Exchange Commission ("SEC") as securities. *See*, *e.g*., *SEC v. Plexcorps*, 17-CV-7007 (E.D.N.Y. Filed Dec. 1, 2017) SEC Compl., ECF No. 1 ("This is an emergency action to stop Lacroix, a recidivist securities law violator in Canada, and his partner Paradis-Royer, from further misappropriating investor funds illegally raised through the fraudulent and unregistered offer and sale of securities called 'PlexCoin' or 'PlexCoin Tokens' in a purported 'Initial Coin Offering.'"); *see also* Jon Hill, *Accused Fraudster Says Cryptocurrencies Aren't Securities*, Feb. 27, 2018 ("According to the government, those blockchain based tokens were securities . . .").

5. Regulation by the Treasury Department's Financial Enforcement Network ("FinCEN"). *See*, *e.g*., FinCEN, *Treasury's First Action Against a Foreign-Located Money Services Business*, U.S. Department of the Treasury, Jul. 27, 2017 ("The Financial Crimes Enforcement Network (FinCEN), working in coordination with the U.S. Attorney's Office for the Northern District of California, assessed a $110,003,314 civil money penalty today against BTC-e [a virtual currency exchange] for willfully violating U.S. anti-money laundering laws.").

6. Regulation by the Internal Revenue

Service ("IRS"). *See*, *e.g.*, *United States v. Coinbase*, *Inc*., No. 17-CV-01431-JSC, 2017 WL 3035164, at *1 (N.D. Cal. July 18, 2017) ("In March 2014, the IRS issued Notice 2014-21, which describes how the IRS applies U.S. tax principles to transactions involving virtual currency. (Case No.

12 *12

3:16-cv-06658-JSC, Dkt. No. 2-4 at 3 ¶ 6.) In Notice 2014-21, the IRS stated its position: virtual currencies that can be converted into traditional currency are property for tax purposes, and a taxpayer can have a gain or loss on the sale or exchange of a virtual currency, depending on the taxpayer's cost to purchase the

13 virtual currency.").

7. Regulation by private exchanges. *See*, *e.g*., Asian Review, *Japan Tries Light Touch in Bringing Cryptocurrencies out of Regulatory Limbo*, NIKKEI, Sept. 30, 2017 ("[T]here is a growing need for exchange operators to self-police to protect investors from taking on too much risk and other dangers.").

8. State regulations. *See*, *e.g*., Press Release, *DFS Grants Virtual Currency License to Coinbase*, *Inc*., N.Y. Department of Financial Services, Jan. 17, 2017 ("DFS has approved six firms for virtual currency charters or licenses, while denying those applications that did not meet DFS's standards. In addition to bitFlyer USA, DFS has granted licenses to Coinbase Inc., XRP II and Circle Internet Financial, and charters to Gemini Trust Company and itBit Trust Company.").

9. A combination of any of the above.

2. Oversight by CFTC

The CFTC is one of the federal administrative bodies currently exercising partial supervision of virtual currencies. Christopher Giancarlo, *Chairman Giancarlo Statement on Virtual Currencies*, CFTC, Jan. 4, 2018 ("One thing is certain: ignoring virtual currency trading will not make it go away. Nor is it a responsible regulatory strategy. The CFTC has an important role to play.").

Administrative and civil action has been utilized by the CFTC to expand its control:

> On September 17, 2015, the [CFTC] issued an [administrative] order (the Coinflip Order) filing and simultaneously settling charges against Coinflip, Inc. (Coinflip)

*13

> and its chief executive officer. In the Coinflip Order, the CFTC took the view for the first time that bitcoin and other virtual currencies are commodities subject to the Commodity Exchange Act (CEA) and CFTC regulations.

Conrad Bahlke, *Recent Developments in the Regulatory Treatment of Bitcoin*, 28 No. 1 Intell. Prop. & Tech. L.J. 6 (2016) (internal citations omitted); *see also* Reuters, *U.S. CFTC Sues Three Virtual Currency Operators for Fraud*, N.Y. Times, Jan. 19, 2018 ("The U.S. derivatives watchdog said on Friday that it has filed charges against three separate virtual currency operators alleging the defendants had defrauded customers and broken other commodity trading rules, in a further sign regulators globally are cracking down on the emerging asset class."); *CFTC Charges Randall Crater*, *Mark Gillespie and My Big Coin Pay Inc. with Fraud and Misappropriation in Ongoing Virtual Currency Scam*, Jan. 24, 2018 ("The [CFTC] today announced the filing of a federal court enforcement action under seal on January 16, 2018, charging commodity fraud and misappropriation related to the ongoing solicitation of customers for a virtual currency known as My Big Coin . . .").

Legitimization and regulation of virtual currencies has followed from the CFTC's allowance of futures trading on certified exchanges. Akin Oyedele, *Bitcoin Futures Trading gets Green Light from [U.S.] Regulators*, Business Insider, Dec. 1, 2017 ("In a statement, the CFTC said the Chicago Mercantile Exchange and the CBOE Futures Exchange self-certified new contracts for bitcoin futures products. The Cantor Exchange self-certified a new contract for bitcoin binary options. The futures contracts will make it possible to bet on bitcoin prices without buying the cryptocurrency."). Two futures exchanges, Chicago Mercantile Exchange and the CBOE Futures Exchange, as of February 23, 2018, exceeded "$150 million in daily trading volume." CFTC Brief, at 6. The CFTC has "actively policed" futures exchanges for "violating core principles" such as "failing to enforce its prohibitions against unlawful wash trading and
14 *14 prearranged trades." *Id.; see In Re TeraExchange LLC*, CFTC No.15-33, 2015 WL 5658082 (Sept. 24, 2015).

3. Concurrent Oversight from Other Agencies

The SEC, IRS, DOJ, Treasury Department, and state agencies have increased their regulatory action in the field of virtual currencies without displacing CFTC's concurrent authority. Most current regulatory action takes the form of pursuing criminal and fraudulent conduct after it occurs.

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> A new division of the Securities and Exchange Commission dedicated to so-called "initial coin offerings" (ICOs) filed its first charges on Friday, targeting a scam that reportedly raised $15 million from thousands of investors by promising a 13-fold profit in less than a month.
>
> In a criminal complaint filed in Brooklyn federal court, the new SEC division, known as the Cyber Unit, describes how Dominic Lacroix sold digital tokens known as "PlexCoins" as part of a purported plan "to increase access to cryptocurrency services" across the world.

Jeff John Roberts, *The SEC's New Cyber Unit Just Filed Its First Charges Over an ICO Scam*, Dec. 4, 2017; Robert J. Anello, *New-Wave Legal Challenges for Bitcoin and Other CryptoCurrencies*, Law Journal Newsletters, Nov. 2017 ("Over the last few months the SEC has demonstrated that it intends to pursue enforcement of securities law on certain cryptocurrency transactions, especially increasingly popular [Initial Coin Offerings], in response to concerns about fraud and manipulation."); Tara Siegel Bernard, *When Trading in Bitcoin*, *Keep the Tax Man in Mind*, N.Y. Times, Jan. 18, 2018 ("In late 2016, the I.R.S. made it clear that it was searching for cryptocurrency tax evaders: The agency sent a broad request to Coinbase, the largest Bitcoin exchange in the United States, requesting records for all customers who bought digital currency from the company from 2013 to 2015."). IV. Law

*15

A. Jurisdiction

District courts have jurisdiction over any action in which the United States is a plaintiff. U.S. Const. Art. III § 2 ("The judicial Power shall extend to all Cases . . . [or] Controversies to which the United States shall be a Party."); 28 U.S.C. § 1345 ("Except as otherwise provided by Act of Congress, the district courts shall have original jurisdiction of all civil actions, suits or proceedings commenced by the United States, or by any agency or officer thereof expressly authorized to sue by Act of Congress.").

Under 28 U.S.C. § 1331 district courts also "have original jurisdiction of all civil actions arising under the Constitution, laws, or treaties of the United States." *See U.S. ex rel. Thistlethwaite v. Dowty Woodville Polymer, Ltd.*, 110 F.3d 861, 864 (2d Cir. 1997) ("[T]he subject matter jurisdiction provisions of Title 28 having broadest application are those granting the district courts power to entertain cases based on federal questions.").

B. Standing

Pursuant to Title 7 U.S.C. § 13a-1(a) the CFTC may seek injunctive or other relief when it believes that a person or entity is in violation of the CEA. ("[T]he Commission may bring an action in the proper district court of the United States . . . to enjoin such act or practice, or to enforce compliance with this chapter, or any rule, regulation or order thereunder, and said courts shall have jurisdiction to entertain such actions."); *see also U.S. Commodity Futures Trading Comm'n v. Parnon Energy Inc.*, 875 F. Supp. 2d 233, 241 (S.D.N.Y. 2012) ("The Commission may [] bring claims alleging violations of the CEA."). Relief may be sought in the "district wherein the defendant is found or is an inhabitant or transacts business or in the district where the act or practice occurred, is occurring, or is about to occur." Title 7 U.S.C. § 13a-1(e).

16 1. Enforcement Power of CFTC *16

Exclusive jurisdiction over "accounts, agreements . . . and *transactions involving swaps or contracts of sale of a commodity for future delivery*" has been granted to the CFTC. Title 7 U.S.C. § 2 (emphasis added). Any commodity traded as a future must be traded on a commodity exchange approved by the CFTC. Title 7 U.S.C. § 6.

The CEA and its "remedial statutes" are to be "construed liberally" to allow for broad market protection. *R&W Tech. Servs. Ltd. v. Commodity Futures Trading Comm'n*, 205 F.3d 165, 173 (5th Cir. 2000) ("In 1974, Congress gave the Commission even greater enforcement powers, in part because of the fear that unscrupulous individuals were encouraging amateurs to trade in the commodities markets through fraudulent advertising. Remedial statutes are to be construed liberally, and in an era of increasing individual participation in commodities markets, the need for such protection has not lessened.").

The court generally defers to an agency's interpretation of a statute "that the agency is responsible for administering." *Sierra Club, Inc. v. Leavitt*, 488 F.3d 904, 911-12 (11th Cir. 2007) (citing *Chevron U.S.A. Inc. v. NRDC*, 467 U.S. 837 (1984)); *Commodity Futures Trading Comm'n v. Am. Precious Metals, LLC*, 845 F. Supp. 2d 1279, 1282-83 (S.D. Fla. 2011) ("*Chevron* applies to the instant case because the CFTC is construing a jurisdictional provision of the CEA—a statute it is responsible for administering.") (emphasis in original).

Full deference is dependent on whether the agency's interpretation followed a formal rulemaking process. *Commodity Futures Trading Comm'n v. Sterling Trading Grp., Inc.*, 605 F. Supp. 2d 1245, 1265-66 (S.D. Fla. 2009) (citing *TVA v. Whitman*, 336 F.3d 1236, 1250 (11th Cir. 2003)) ("*Chevron* deference is confined to those instances in which the agency renders its interpretation in the course of a rulemaking proceeding or adjudication. [E]ven if an agency's interpretation of its own statute is advanced in the
17 course of litigation rather than through a *17
rulemaking or agency adjudication, courts will still pay some deference to the agency's interpretation.").

a. Virtual Currencies are Commodities

Black's Law Dictionary defines a commodity as "an article of trade or commerce." Bryan Garner, *Black's Law Dictionary*, (10th ed. 2014). Merriam Webster defines it as "[a]n economic good . . . [or] an article of commerce . . ." Merriam Webster, https://www.merriam-webster.com/dictionary/commodity (last visited Feb. 5, 2018).

Commentators have argued that based on common usage, virtual currency should be interpreted as a commodity.

> It would make sense for regulators to treat Bitcoin as a commodity. Commodities are generally defined as "goods sold in the market with a quality and value uniform throughout the world." This categorization would be appropriate because it realistically reflects the economic behavior of Bitcoin users and squares with traditional economic conceptions of exchange.

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Mitchell Prentis, *Digital Metal: Regulating Bitcoin As A Commodity*, 66 Case W. Res. L. Rev. 609, 626 (2015).

Some propose that because virtual currencies provide a "store of value" they function as commodities:

> A commodity is any item that "accommodates" our physical wants and needs. And one of these physical wants is the need for a store of value. Throughout history humans have used different commodities as a store of value - even cocoa beans - but, more persistently, gold. In contrast, a security is any instrument that is "secured" against something else. As a currency is usually secured by a commodity or a government's ability to tax and defend, it is considered to be a security. By these definitions, bitcoin with a lower case "b," is a commodity, and not a currency, while Bitcoin with a capital "B" is the technology, or network, that bitcoin moves across. The analogy would be Shale technology versus shale oil.

Jeff Currie, *Bullion Bests bitcoin*, *Not Bitcoin*, Goldman Sachs Global Investment Research, Mar. 11, 2014. *18

Others argue virtual currencies are commodities because they serve as a type of monetary exchange:

> Bitcoin should primarily be considered a commodity because it serves the function of money in its community of users. Users exchange Bitcoins to obtain property that they desire. In his seminal work, *Man*, *Economy*, *and State*, Murray Rothbard argues that all monetary exchanges are actually indirect commodity exchanges. Rothbard supports his proposition by tracing the development of money and exchange. Before the widespread adoption of a common form of money, people had to engage in bartering, or "direct exchange," in order to complete transactions . . .
>
> Furthermore, while Bitcoin acts as a money commodity in its community of users, from a pricing standpoint, it is valued like other commodities. The price of traditional commodities, like gold, silver, and agricultural products, vary in accordance with their demand and scarcity. When more people want a commodity that has a fixed supply, the price rises.
>
> Similarly, the price of Bitcoin fluctuates according to the same fixed supply model. Bitcoins are scarce because the algorithm controlling how many Bitcoins are released into the market through mining [] is designed to taper the supply of bitcoins, until no more are created. Bitcoins are considered rare because there is a fixed supply of them, leading users to be willing to pay increasing prices to control them. The value of a Bitcoin is ultimately driven by supply and demand—a coin is worth whatever someone is willing to pay for it.

Prentis, at 628-29 (internal citations omitted).

b. Commodity Exchange Act's Definition of "Commodity"

CEA defines "commodities" as "wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil, and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, *and all other goods and articles . . . and all services*, *rights*, *and interests . . . in which contracts for future delivery are presently or in the future dealt in*." Title 7 U.S.C. § 1(a)(9) (emphasis added). *19

The original grant of power to the CEA was designed to control trading in agricultural commodities. Other goods, as well as services, rights and interests, are now covered by the statute. *See*, *e.g.*, *United States v. Brooks*, 681 F.3d 678, 694 (5th Cir. 2012) ("Natural gas is plainly a 'good' or 'article.' The questions thus turns on whether it is a good 'in which contracts for future delivery are presently or in the future dealt with.'").

The CEA covers intangible commodities. *See*, *e.g.*, *In re Barclays PLC*, CFTC No. 15-25 (May 20, 2015) (regulating fixed interest rate benchmarks as commodities); *cf*. *Andrews v. Blick Art Materials*, *LLC*, 268 F. Supp. 3d 381, 395-96 (E.D.N.Y. 2017) (quoting *Pennsylvania Dep't of Corr*. *v*. *Yeskey*, 524 U.S. 206, 212 (1998)) ("That the meteoric rise of virtual reality through the Internet and its impact on communal and commercial affairs could not have been anticipated by Congress does not mean the law's application to the Internet and website is ambiguous; 'the fact that a statute can be applied in situations not expressly anticipated by Congress does not demonstrate ambiguity. It demonstrates breadth.'").

c. CFTC's Interpretation of "Commodity"

After an administrative proceeding in 2015, the CFTC issued an order finding, for the first time, that virtual currencies can be classified as commodities. *In the Matter of: Coinflip, Inc.*, CFTC Docket No. 15-29 ("Bitcoin and other virtual currencies are encompassed in the definition and properly defined as commodities.").

Multiple statements defining virtual currency as a commodity have been issued by the CFTC. *See* App. B, *CFTC Primer*, at 11 ("The definition of 'commodity' in the CEA is broad . . . It can mean physical commodity, such as an agricultural product . . . It can mean currency or interest rate."); *CFTC Launches Virtual Currency Resource Web Page*, Press Release, Dec. 15, 2017 ("Bitcoin and other virtual currencies have been
20 determined to be commodities under the *20 Commodity Exchange Act (CEA). The [CFTC] primarily regulates commodity derivatives contracts that are based on underlying commodities. While its regulatory oversight authority over commodity cash markets is limited, the CFTC maintains general anti-fraud and manipulation enforcement authority over virtual currency cash markets as a commodity in interstate commerce.").

d. Derivative Contracts and Futures

Regulatory authority over commodities traded as futures and derivatives has been granted to CFTC. *Inv. Co. Inst. v. Commodity Futures Trading Comm'n*, 720 F.3d 370, 372 (D.C. Cir. 2013) ("The Commodity Exchange Act (CEA), Title 7, United States Code, Chapter 1, establishes and defines the jurisdiction of the Commodity Futures Trading Commission. Under this Act, the Commission has regulatory jurisdiction over a wide variety of markets in futures and derivatives, that is, contracts deriving their value from underlying
21 assets.").

Title 7 U.S.C. § 9(1) of the CEA makes it unlawful for any person to:

> use or employ, in connection with any swap, *or a contract of sale of any commodity in interstate commerce*, or for future delivery on or subject to the rules of any registered entity, *any manipulative or deceptive device or contrivance*, in contravention of such rules and regulations as the Commission shall promulgate by not later than 1 year after July 21, 2010 . . . (emphasis added).

17 C.F.R. § 180.1 further defines the regulatory power of the CFTC:

> (a) It shall be unlawful for any person, directly or indirectly, in connection with any swap, or contract of sale of any commodity in interstate commerce, or contract for future delivery on or subject to the rules of any registered entity, to intentionally or recklessly:
>
> > (1) Use or employ, or attempt to use or employ, any manipulative device, scheme, or artifice to defraud;
> > (2) Make, or attempt to make, any untrue or misleading statement of a material fact or to omit to state a material fact necessary in order to make the statements made not untrue or misleading;
> > (3) Engage, or attempt to engage, in any act, practice, or course of business, which operates or would operate as a fraud or deceit . . .

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Liability, under the CEA, for commodity fraud, is shown by: "(1) the making of a misrepresentation, misleading statement, or a deceptive omission; (2) scienter; and (3) materiality." *Commodity Futures Trading Comm'n, v. Commodity Inv. Grp., Inc.*, No. 05 CIV 5741(HB), 2006 WL 353466, at *1

(S.D.N.Y. Feb. 11, 2006) (quoting *CFTC v. R.J. Fitzgerald & Co., Inc.*, 310 F.3d 1321, 1328 (11th Cir. 2002)).

e. Regulation of Spot Market Fraud

The CFTC has recently expanded its enforcement to fraud related to spot markets underlying the (already regulated) derivative markets. *See*, *e.g.*, App. B, *CFTC Primer* (finding the CFTC has jurisdiction "if there is fraud or manipulation involving a virtual currency traded in interstate commerce"); *CFTC v. Gelfman Blueprint, Inc.*, Case No. 17-7181 (S.D.N.Y. Filed Sept. 21, 2017) (suit brought by the CFTC alleging a Bitcoin Ponzi scheme, not involving future contracts).

In *Gelfman*, as in the instant case, the CFTC relied on the broad statutory authority in Section 9(1) of the CEA, and regulatory authority under 17 C.F.R. § 180.1. Specifically, the language in § 180.1 prohibiting "any person, directly or indirectly, in connection with any . . . contract of sale of any commodity in interstate commerce" from using a "manipulative device, scheme, or artifice to defraud," or making "any untrue or misleading statement of a material fact."

The portion of the statute delegating oversight authority over *"contract of sale of any commodity in interstate commerce"* allows CFTC to enforce its mandate in cases not directly involving future trades. 17 C.F.R. § 180.1 (emphasis added); *see* Gary DeWaal, *CFTC Files Charges Alleging Bitcoin Ponzi Scheme Not Involving Derivatives*, Sept. 24, 2017 ("The CFTC brought its current action [*Gelfman*] under a relatively new provision
22 of law (enacted as part of *22 the Dodd-Frank Wall Street Reform and Consumer Protection Act) and Commission regulation that prohibits any person from using a manipulative or deceptive device or contrivance in connection with any 'contract for sale of any commodity in interstate commerce' - not solely in connection with swaps or a commodity for future delivery.").

Where a futures market exists for a good, service, right, or interest, it may be regulated by CFTC, as a commodity, without regard to whether the dispute involves futures contracts. *See*, *e.g.*, *Brooks*, 681 F.3d at 694-95 ("[F]utures contracts for natural gas are traded on NYMEX, and those futures are derivative of natural gas traded at Henry Hub. Nonetheless, the record shows that natural gas may be moved from any location to Henry Hub through the national pipeline system. Thus, it would be peculiar that natural gas at another hub is not a commodity, but suddenly becomes a commodity solely on the basis that it passes through Henry Hub, and ceases to be a commodity once it moves onto some other locale. While the price of that commodity may fluctuate with its location, and the forces of supply and demand at that location, the actual nature of the 'good' does not change.").

CFTC does not have regulatory authority over simple quick cash or spot transactions that do not involve fraud or manipulation. Title 7 U.S.C. § 2(c)(2)(C)(i)(II)(bb)(AA) (The CFTC does not have jurisdiction over "spot" transactions that " [result] in actual delivery within 2 days."). This boundary has been recognized by the CFTC. It has not attempted to regulate spot trades, unless there is evidence of manipulation or fraud. *See* App. C, CFTC Chair, Congressional Testimony ("[T]he CFTC does not have authority to conduct regulatory oversight over spot virtual currency platforms or other cash commodities, including imposing registration requirements, surveillance and monitoring, transaction reporting, compliance
23 with personnel *23 conduct standards, customer education, capital adequacy, trading system safeguards, cyber security examinations or other requirements.").

2. Concurrent Jurisdiction

Federal agencies may have concurrent or overlapping jurisdiction over a particular issue or area. *See*, *e.g.*, Todd S. Aagaard, *Regulatory Overlap*, *Overlapping Legal Fields*, *and Statutory*

Discontinuities, 29 Va. Envtl. L.J. 237, 240 (2011)) ("[T]he Environmental Protection Agency (EPA) and the Occupational Safety and Health Administration (OSHA) manage overlapping statutory authorities. Both the EPA and OSHA regulate certain risks in the workplace arising from exposures to hazardous and toxic substances.").

Agencies often cooperate to enforce their overlapping powers.

> [Agencies] have explored joint rulemaking, such as the Environmental Protection Agency (EPA) and the Department of Transportation (DOT) collaboration on fuel standards. They have discussed coordination in individual-level adjudication, such as the Department of Justice (DOJ) and the Department of Homeland Security (DHS) partnering in cases involving persons without proper documentation. And they have analyzed agency collaboration in shaping policy in complex and novel areas, such as work by DHS and the National Security Agency (NSA) to combat cyber threats.

Daniel A. Farber & Anne Joseph O'Connell, *Agencies As Adversaries*, 105 Cal. L. Rev. 1375, 1384 (2017); *but see Hunter v. F.E.R.C.*, 711 F.3d 155, 157 (D.C. Cir. 2013) ("Stated simply, Congress crafted CEA section 2(a)(1)(A) to give the CFTC exclusive jurisdiction over transactions conducted on futures markets.").

C. Preliminary Injunction Standard

Under Title 7 U.S.C. § 13a-1(a) the CFTC may seek injunctive or other relief when it concludes that a person or entity is in violation of the CEA. "The CFTC is entitled to a preliminary injunction upon a *prima facie* showing that defendants have violated the Act and 'that there is a reasonable likelihood that the wrong will be repeated.'" 24 *Commodity Futures* *24 *Trading Comm'n, v. Commodity Inv. Grp., Inc.*, No. 05 CIV 5741(HB), 2006 WL 353466, at *1 (S.D.N.Y. Feb. 11, 2006) (quoting *CFTC v. British Am. Commodity Options Corp.*, 560 F.2d 135, 141 (2d Cir.1977)). When enforcing a statutorily prescribed injunction, the CFTC "need not prove irreparable injury or the inadequacy of other remedies as required in private injunctive suits." *British Am.*, 560 F.2d at 141. Likelihood of future violations may be inferred from a "defendant's past conduct." *CFTC v. Am. Bd. of Trade, Inc.*, 803 F.2d 1242, 1251 (2d Cir. 1986). V. Application of Law

A. CFTC Standing

The CFTC has standing pursuant to Title 7 U.S.C. § 13a-1(a) to seek injunctive and other relief related to misleading advice, and the fraudulent scheme and misappropriation of virtual currencies by defendants.

1. Virtual Currencies as Commodities

Virtual currencies can be regulated by CFTC as a commodity. Virtual currencies are "goods" exchanged in a market for a uniform quality and value. Mitchell Prentis, *Digital Metal: Regulating Bitcoin As A Commodity*, 66 Case W. Res. L. Rev. 609, 626 (2015). They fall well-within the common definition of "commodity" as well as the CEA's definition of "commodities" as "all other goods and articles . . . in which contracts for future delivery are presently or in the future dealt in." Title 7 U.S.C. § 1(a)(9).

The jurisdictional authority of CFTC to regulate virtual currencies as commodities does not preclude other agencies from exercising their regulatory power when virtual currencies function differently than derivative commodities. *See, e.g.*, Jay Clayton [SEC Chair] and Christopher Giancarlo [CFTC Chair], *Regulators are Looking* 25 *at Cryptocurrency*, Wall Street *25 Journal, Jan. 24, 2018 ("The SEC does not have direct oversight of transactions in currencies or commodities. Yet some products that are labeled cryptocurrencies have characteristics that make them securities. The offer, sale and trading of such products must be carried out in compliance with securities law. The SEC will vigorously pursue those who seek to evade the registration, disclosure and antifraud requirements of our securities laws.").

The Chicago Mercantile Exchange Inc. ("CME") has filed an *amicus* brief. *See* ECF No. 27, Mar. 6, 2018. It claims to operate the "world's leading derivatives marketplace." *Id*. at 1. It supports the view that virtual currencies are commodities subject to the CFTC's regulatory protections. It writes:

> CME offers for the Court's consideration an explanation of the possible consequences of a determination that a virtual currency such as bitcoin is not a commodity. Such a determination would put in jeopardy CME's and its market participants' expectation to rely on . . . the CFTC's regulatory protections for commodity derivatives contracts based on virtual currencies. This legal uncertainty would substantially disrupt the settled expectations of CME and numerous market participants who are trading bitcoin futures for purposes of hedging cash market exposures or making a market in bitcoin futures by offering liquidity, in addition to market professionals that clear, broker or manage virtual currency futures trading activity.

Id. at 2.

2. CFTC Jurisdiction Over Virtual Currency Fraud

CFTC has jurisdictional authority to bring suit against defendants utilizing a scheme to defraud investors through a "contract [for] sale of [a] commodity in interstate commerce." Title 7 U.S.C. § 9(1). Although the CFTC has traditionally limited its jurisdiction primarily to "future" contracts for commodities, its expansion into spot trade commodity fraud is justified by statutory and regulatory guidelines. *See CFTC v. Gelfman Blueprint, Inc*., Case No. 17-7181 (S.D.N.Y. Filed Sept. 21, 2017); *see also* Gary DeWaal, *CFTC Files Charges Alleging Bitcoin Ponzi Scheme Not Involving Derivatives*, Sept. 24, 2017 ("This 26 CFTC complaint [*CFTC v.* *26 *Gelfman Blueprint, Inc*.] has significant ramifications beyond its four corners. It represents a powerful statement by the Commission that it will exercise jurisdiction over cryptocurrencies when there is potential fraud - even if the fraud does not involve derivatives based on cryptocurrencies.").

Language in 7 U.S.C. § 9(1), and 17 C.F.R. § 180.1, establish the CFTC's regulatory authority over the manipulative schemes, fraud, and misleading statements alleged in the complaint. 17 C.F.R. § 180.1 ("It shall be unlawful for any person, directly or indirectly, in connection . . . [with any] contract of sale of any commodity in interstate commerce . . . to [u]se or employ, or attempt to use or employ, any manipulative device, scheme, or artifice to defraud; [m]ake, or attempt to make, any untrue or misleading statement of a material fact or to omit to state a material fact necessary in order to make the statements made not untrue or misleading; [e]ngage, or attempt to engage, in any act, practice, or course of business, which operates or would operate as a fraud or deceit . . .").

B. Prima Facie Showing of Fraud Committed by Defendants

CFTC has made a prima facie showing that the defendants committed fraud by misappropriation of investors' funds and misrepresentation of trading advice and future profits promised to customers. CFTC Brief, at 11 (citing Giglio Decl. ¶ 26) ("[O]nce Defendants had solicited and obtained [] Customer funds for trading by Defendants on behalf of customers, Defendants ceased communicating with the customers and misappropriated the customers' funds."). The intentional nature of the defendants' conduct, as required by 17 C.F.R. § 180.1, is evidenced by the blatant disregard of customers' complaints and their refusal to return investors' funds. *See* Giglio Decl. ¶¶ 29-32; *see also* Hr'g Tr., Mar. 6, 2018.

27 C. Preliminary Injunction *27

A preliminary injunction is granted in favor of the CFTC. The court concludes that without an injunction there is a reasonable likelihood that defendants will continue to violate the CEA. A separate order outlining the terms of the relief is issued. *See* App. A, Prelim. Injunction.

D. Appropriate Research by Court

In deciding jurisdictional, standing and other issues fundamental to the present litigation, the court has engaged in extensive background research, but not on the specific frauds charged. This is appropriate.

The ABA has issued the following opinion related to individual research by the court:

> Easy access to a vast amount of information available on the Internet exposes judges to potential ethical problems. Judges risk violating the Model Code of Judicial Conduct by searching the *Internet for information related to participants or facts in a proceeding. Independent investigation of adjudicative facts generally is prohibited* unless the information is properly subject to judicial notice. The restriction on independent investigation includes individuals subject to the judge's direction and control.

Committee on Ethics and Responsibility, *Independent Factual Research by Judges Via Internet*, Formal Opinion 478, Dec. 8, 2017 (ABA) (emphasis added).

It is appropriate and necessary for the judge to do research required by a case in order to understand the context and background of the issues involved so long as the judge indicates to the parties the research and conclusions, by opinions and otherwise, so they may contest and clarify. *See* Abrams, Brewer, Medwed, et al., *Evidence Cases and Materials* (10th Ed. 2017) (Ch. 9 "Judicial Notice"). It would be a misapprehension of the ABA rule to conclude otherwise.

Adjudicative facts involving defendants' alleged activities have not been the subject of investigation by the court, except at an evidentiary
28 hearing. *See* Hr'g Tr., Mar. 6, 2018. *28 VI. Conclusion

CFTC has standing to exercise its enforcement power over fraud related to virtual currencies sold in interstate commerce. A preliminary injunction is granted in favor of the CFTC. *See* App. A, Prelim. Injunction.

The individual defendant's pro se motion to "Dismiss for Lack of Jurisdiction" is denied. ECF No. 18, Feb. 15, 2018. This court has subject matter jurisdiction pursuant to 28 U.S.C. §§ 1331 and 1345. The CFTC has adequately pled and for purpose of a preliminary injunction proved its claim of fraud in violation of the CEA.

Any person claiming improper application of the injunctive power of the court may seek relief by motion.

SO ORDERED.

/s/ Jack B. Weinstein

Jack B. Weinstein

Senior United States District Judge Dated: March 6, 2018

29 Brooklyn, New York *29 Appendix A 18-CV-0361 **ORDER OF PRELIMINARY INJUNCTION AND OTHER RELIEF**

I. INTRODUCTION

On January 18, 2018, Plaintiff Commodity Futures Trading Commission ("Plaintiff" or "Commission") filed a Complaint for Injunctive and Other Equitable Relief and for Civil Monetary Penalties Under the Commodity Exchange Act and Commission Regulations ("Complaint") against Defendants Patrick K. McDonnell ("McDonnell") and CabbageTech, Corp. d/b/a Coin Drop Markets ("CDM") (collectively, "Defendants") pursuant to Section 6c(a) of the Commodity Exchange Act ("Act"), 7 U.S.C. § 13a-1 (2012).

On January 30, 2018, the court directed the parties to appear for an evidentiary hearing at which the court would consider temporary relief and further administration of the action. ECF No. 9. Subsequent Orders directed the parties to address the Commission's authority to bring this action and notified the parties that the court would hear
30 the parties on jurisdictional, *30 standing, and other issues at the hearing, set for March 6, 2018. ECF No. 10, ECF No. 17.

On February 26, 2018, the Commission filed its briefs and supporting documents, including the Brief of Commodity Futures Trading Commission in Support of a Preliminary Injunction and Other Relief, the Declaration of Christopher Giglio, that set forth its arguments, including advocating for the issuance of an order (1) prohibiting Defendants from further violating Section 6(c)(1) of the Act, 7 U.S.C. § 9(1) (2012), and Commission Regulation ("Regulation") 180.1(a), 17 C.F.R. § 180.1(a) (2017); (2) preserving the books and records of Defendants, and providing the Commission with access thereto; and (3) ordering Defendants to submit to an interim accounting on an expedited basis.

On March 6, 2018, the court, with advance notice, *see* ECF No. 23, Feb. 27, 2018, held an evidentiary hearing on the request for preliminary injunction.

The court has considered the Brief of Commodity Futures Trading Commission in Support of a Preliminary Injunction and Other Relief, the Complaint, the Declaration of Christopher Giglio, all filings by Defendant McDonnell to date, and testimony and evidence introduced at the March 6, 2018 hearing. It finds that there is good cause for the entry of this Order and that there is no just reason for delay. The court therefore directs the entry of the following findings of fact, conclusions of law, and preliminary injunction and other equitable relief pursuant to Section 6c of the Act, as amended, 7 U.S.C. § 13a-1.

II. FINDINGS AND CONCLUSIONS THE COURT FINDS AND CONCLUDES AS FOLLOWS:

A. FINDINGS OF FACT

The Parties

1. Plaintiff **Commodity Futures Trading Commission** ("Commission" or "CFTC") is an independent federal regulatory agency that is
31 charged by Congress with the *31 administration and enforcement of the Act, 7 U.S.C. §§ 1-27(f) (2012), and the Regulations promulgated thereunder, 17 C.F.R. pts. 1-190 (2017).

2. Defendant **CabbageTech**, **Corp.** is a New York corporation based on Staten Island, New York. It was incorporated on May 6, 2016. CabbageTech, Corp.'s last known address is 20 Rawson Place, Suite B, Staten Island, New York, 10314. At times, CabbageTech, Corp. did business as **Coin Drop Markets** (together with CabbageTech, Corp, "CDM"). CDM has never registered with the Commission.

3. Defendant **Patrick K. McDonnell** ("McDonnell") is a resident of Staten Island, New York. McDonnell formed, owned, and controlled CabbageTech, Corp. McDonnell has never registered with the Commission

Defendants' Fraud Involving Advice About Trading Virtual Currencies

4. Defendants solicited customers in several of the United States as well as foreign countries to become members of groups supposedly to receive Defendants' virtual currency consulting services and trading advice.

5. In April 2017, Defendants advertised membership in trading groups such as RedliteGreenLite, BTC ("RLGLBTC"), relating to Bitcoin, and RedliteGreenLite, LTC ("RLGLLTC"), relating to Litecoin. These groups purported to provide trading advice and guidance, such as entry and exit prices for day trading of virtual currencies. Defendants also solicited membership or subscription to other groups and services, such as a "Turn-Key Annual Membership" providing access, for instance, to McDonnell's and CDM's supposed virtual currency trading expertise, mentorship, and guidance.

6. CDM's promotional materials made claims that a CDM membership in RLGLLTC would provide "real-time . . . reports [of] critical $LTC entry/exit
32 points via *32 @RLGLLTC 24/7 including holidays/weekends." These promotional materials further made claims that this continuous, ongoing monitoring and trading signals "afford[ed] 'minute-to-minute' price arbitrage, exploitation, and opportunities for swing trading profits." These promotional materials also made claims such as a trading group was "a dedicated team of digital asset trading specialists trend spotting."

7. These materials promised to provide the membership services on an annual basis in exchange for an up-front subscription fee. Defendants further solicited "lifetime" memberships, at a higher price, in a more exclusive trading sector that would provide greater opportunities to profit from virtual currency trading. One such opportunity purported to offer profits as much as a 300% return on an investment in less than a week. In or around May 2017, Defendants created one or more social media chatrooms, purportedly to provide agreed-upon trading advice and services.

8. After receiving subscription payments from multiple CDM Customers, Defendants did not provide to such customers continuous, real-time trading signals, advice, or trading expertise through its social media chatrooms, through online communications such as via Twitter, or through its website. For example, Defendants never provided "real-time . . . reports [of] critical $LTC entry/exit points via @RLGLLTC 24/7 including holidays/weekends." Defendants' RLGLLTC never provided signals that "afford[ed] 'minute-to-minute' price arbitrage, exploitation, and opportunities for swing trading profits."

9. Defendants misappropriated CDM Customers' funds. By July 2017, Defendants shut down the website and chatroom, deleted social media accounts, ceased communicating with customers,
33 and kept the customers' funds. *33

Defendant's Fraud Involving Management of Customer Investments in Virtual Currency

10. McDonnell described himself in solicitations as a "professional trader," and CDM's website included a purported example of a single virtual currency trade that had generated more than an approximately 1,000% return.

11. Instead of achieving enormous gains on behalf of CDM Customers, once Defendants had solicited and obtained CDM Customer funds for trading by Defendants on behalf of customers, Defendants ceased communicating with the customers and misappropriated the customers' funds.

12. In or around May 2017, after being solicited by McDonnell, one CDM Customer provided Litecoin to Defendants for trading by McDonnell on the customer's behalf. McDonnell told this customer that he would use the customer's funds to trade the "volatility" of Litecoin. In fact, Defendants misappropriated this customer's funds and ultimately ceased communicating with the customer.

CDM's Controlling Person

13. McDonnell founded and created CDM, and controlled content on the CDM website and related social media. McDonnell controlled bank

and virtual currency accounts to which he directed CDM Customers to send money for the purchase of CDM services and for Defendants-managed trading. McDonnell was responsible for developing and disseminating the false and misleading information about CDM to CDM Customers through CDM's solicitation materials.

34 *34

B. CONCLUSIONS OF LAW

Jurisdiction and Venue

14. The Court has jurisdiction over the subject matter of this action under 28 U.S.C. § 1331 (2012) and 28 U.S.C. § 1345 (2012). Section 6c(a) of the Act, 7 U.S.C. § 13a-1 (2012), authorizes the Commission to seek injunctive and other relief against any person whenever it shall appear to the Commission that such person has engaged, is engaging in, or is about to engage in any act or practice constituting a violation of any provision of the Act, or any rule, regulation, or order thereunder.

15. Venue properly lies in this District, pursuant to Section 6c(e) of the Act, 7 U.S.C. § 13a-1(e) (2012), because Defendants are found in, inhabit, or transact business in this District, and because acts and practices in violation of the Act occurred within this District, among other places.

Injunctive Relief is Appropriate

16. The Commission has presented a prima facie case for the purpose of obtaining a preliminary injunction based on the fact that Defendants have engaged or are engaging in violations the Act and Commission Regulations as set forth in the Complaint.

17. The Commission has demonstrated a reasonable likelihood of future violations by the Defendants.

18. A preliminary injunction and other relief are warranted in light of the allegations set forth in the Complaint, evidence submitted at a hearing held by the court, the Commission's likelihood of success on the merits of its claims against the Defendants, and the reasonable likelihood of

35 future violations by the Defendants. *35

III. RELIEF GRANTED

A. PRELIMINARY INJUNCTIVE RELIEF

IT IS HEREBY ORDERED that:

19. Defendants, their officers, agents, servants, employees, successors, assigns, and attorneys, and all persons in active concert or participation with Defendants who receive notice of this Order by personal service or otherwise, are hereby restrained, enjoined, and prohibited until further order of the court, from directly or indirectly, in connection with any swap, or contract of sale of any commodity in interstate commerce, or contract for future delivery on or subject to the rules of any registered entity, intentionally or recklessly:

A. using or employing, or attempting to use or employ, any manipulative device, scheme, or artifice to defraud;

B. making, or attempting to make, any untrue or misleading statement of a material fact or to omit to state a material fact necessary in order to make statements made not untrue or misleading; and

C. engaging, or attempting to engage, in any act, practice, or course of business, which operates or would operate as a fraud or deceit upon any person; in violation of Section 6(c)(1) of the Act, 7 U.S.C. § 9(1) (2012), or Commission Regulation 180.1(a), 17 C.F.R. § 180.1(a) (2017).

20. Defendants, their officers, agents, servants, employees, successors, assigns, or attorneys, and all persons in active concert or participation with Defendants who receive notice of this Order by personal service or otherwise, are hereby restrained, enjoined, and prohibited until further order of the court, from directly or indirectly:

A. Trading on or subject to the rules of any registered entity, as that term is defined in Section
36 1a(40) of the Act, 7 U.S.C. § 1a(40) (2012); *36

B. Entering into any transactions involving "commodity interests" (as that term is defined in Regulation 1.3(yy), 17 C.F.R. § 1.3(yy) (2017)) for their own personal account or for any account in which they have a direct or indirect interest;

C. Having any commodity interests traded on their behalf;

D. Controlling or directing the trading for or on behalf of any other person or entity, whether by power of attorney or otherwise, in any account involving commodity interests;

E. Soliciting, receiving, or accepting any funds from any person for the purpose of purchasing or selling any commodity;

F. Applying for registration or claiming exemption from registration with the Commission in any capacity, and engaging in any activity requiring such registration or exemption from registration with the Commission, except as provided for in Regulation 4.14(a)(9), 17 C.F.R. § 4.14(a)(9) (2017); and

G. Acting as a principal (as that term is defined in Regulation 3.1(a), 17 C.F.R. § 3.1(a) (2017)), agent, or any other officer or employee of any person (as that term is defined in Section 1a(38) of the Act, 7 U.S.C. § 1a(38) (2012)) registered, exempted from registration, or required to be registered with the Commission except as provided for in Regulation 4.14(a)(9), 17 C.F.R. § 4.14(a)(9) (2017). B. **MAINTENANCE OF AND ACCESS TO BUSINESS RECORDS IT IS FURTHER ORDERED** that:

21. Defendants are restrained from directly or indirectly destroying, mutilating, erasing, altering, concealing or disposing of, in any manner, directly or indirectly, any documents that relate to the business practices or business or personal finances
37 of any Defendant. *37

22. Any financial or brokerage institution, business entity, or person that receives notice of this Order by personal service or otherwise, shall not:

A. directly or indirectly destroy, alter or dispose of, in any manner, any records relating to the business activities and business and personal finances of any Defendant; and

B. deny a request by the Commission to inspect any records pertaining to any account or asset owned, controlled, managed or held by Defendants, or managed or held on behalf of, or for the benefit of, any Defendants, including, but not limited to, originals or copies of account applications, account statements, signature cards, checks, drafts, deposit tickets, transfers to and from the accounts, debit and credit instruments or slips, currency transaction reports, 1099 forms, and safe deposit box logs. As an alternative to allowing inspection of records, a financial or brokerage institution, business entity or other person may provide full un-redacted copies of records requested by the Commission.

C. ACCOUNTING AND PRODUCTION OF DOCUMENTS

IT IS FURTHER ORDERED that:

23. Within five (5) business days following the service of this Order, Defendants shall submit in writing and serve upon the Commission an accounting identifying:

A. all transfers or payments of funds to them or any other entity controlled by them from any individual or entity in connection with the misconduct described in the Complaint. The identification shall include the amount of each such transfer or payment, the date of the transfer or payment, and the name, address, account number and financial institution of the party making and the party receiving the transfer or
38 payment; *38

B. in detail, the precise disposition of each such transfer or payment and any assets derived therefrom;

C. by name and address, all persons, entities and accounts currently holding funds or assets derived from such transfers or payments and the reason each received the funds or assets. The identification shall include the amount each received, the date received, the reason received, the institution and account number or location in which the funds or other assets are held and the name, address, account number and financial institution of the person or entity who provided each with the funds or other assets;

D. assets of every type and description presently owned by or held for the direct or indirect benefit, or subject to the direct or indirect control, of any Defendant, whether in the United States or elsewhere; and

E. the identification number of each account or other asset controlled, managed, or held by, on behalf of, or for the benefit of a Defendant, either individually or jointly; the balance of each such account, or a description of the nature and value of such asset as of the close of business on the day on which this Order is served, and, if the account or other asset has been closed or removed, the date closed or removed, the total funds removed in order to close the account, and the name of the person or entity to whom such account or other asset was remitted; and the identification of any safe deposit box that is owned controlled, managed, or held by, on behalf of, or for the benefit of a Defendant, either individually or jointly, or is otherwise subject to access by Defendants.

24. Upon request by the Commission, each Defendant shall promptly provide the Commission with copies of all records or other documentation pertaining to any account or asset identified in response to Paragraph 23 above, including, but not
39 limited to, originals or copies of *39 account applications, account statements, signature cards, checks, drafts, deposit tickets, transfers to and from the accounts, all other debit and credit instruments or slips, currency transaction reports, Internal Revenue Service Forms 1099, and safe deposit box logs.

IV. <u>MISCELLANEOUS PROVISIONS</u>

25. *Definitions*. For the purposes of this Order, the following definitions apply:

A. "Assets" means any legal or equitable interest in, right to, or claim to, any real or personal property, whether individually or jointly, directly or indirectly controlled, and wherever located, including, but not limited to: chattels, goods, instruments, equipment, fixtures, general intangibles, effects, leaseholds, mail or other deliveries, inventory, checks, notes, accounts (including, but not limited to, bank accounts and accounts at other financial institutions), credits, receivables, lines of credit, contracts (including spot, futures, options, or swaps contracts), insurance policies, and all cash, wherever located, within or outside the United States.

B. The term "document" is synonymous in meaning and equal in scope to the broad usage of the term in Federal Rule of Civil Procedure 34(a).

26. *Service of this Order*. Copies of this Order may be served by any means, including mail, electronic mail, facsimile transmission, Fedex, and United Parcel Service, upon any financial institution or other entity or person that may have possession, custody, or control of any document or asset of Defendants, or that may be subject to any provision of this Order.

27. *Bond Not Required of Plaintiff*. Plaintiff is an agency of the United States, and therefore, pursuant to Section 6c(b) of the Act, 7 U.S.C. §13a-1(b) (2012), no bond is required prior to
40 entry of this Order. *40

28. *Continuing Jurisdiction of this Court.* This Order shall remain in effect until further order of the court. The court shall retain jurisdiction over this action to ensure compliance with this Order and for all other purposes related to this action.

29. Any person claiming improper application of the injunctive power of the court may seek relief by motion.

SO ORDERED.

/s/ Jack B. Weinstein

Jack B. Weinstein

Senior United States District Judge Dated: March 6, 2018

41 Brooklyn, New York *41

Image materials not available for display.

Tab 44 – Ross Ulbricht's Full Testimony

Please see the following link for Ross Ulbricht's full testimony:

https://bitcoinmagazine.com/culture/silk-road-ross-ulbricht-from-prison

Money Services Business Definition

The term "money services business" includes any person (/person) doing business, whether or not on a regular basis or as an organized business concern, in one or more of the following capacities:

(1) Currency dealer or exchanger.
(2) Check casher.
(3) Issuer of traveler's checks, money orders or stored value.
(4) Seller or redeemer of traveler's checks, money orders or stored value.
(5) Money transmitter.
(6) U.S. Postal Service.

An activity threshold of greater than $1,000 per person per day in one or more transactions applies to the definitions of: currency dealer or exchanger; check casher; issuer of traveler's checks, money orders or stored value; and seller or redeemer of travelers' checks, money orders or stored value. The threshold applies separately to each activity -- if the threshold is not met for the specific activity, the person (/person) engaged in that activity is not an MSB on the basis of that activity.

No activity threshold applies to the definition of money transmitter. Thus, a person who engages as a business in the transfer of funds is an MSB as a money transmitter, regardless of the amount of money transmission activity.

Notwithstanding the previous discussion, the term "money services business" does not include:

- A bank, as that term is defined in 31 CFR 1010.100(d) (formerly 31 CFR 103.11(c)), or
- A person registered with, and regulated or examined by, the Securities and Exchange Commission or the Commodity Futures Trading Commission.

For the complete regulatory definition of "money services business", see 31 CFR 1010.100(ff) (formerly 31 CFR 103.11(uu)).

Note: Each money services business (MSB) is a financial institution (/financial-institution-definition). For the regulatory definition of "financial institution," see 31 CFR 1010.100(t) (formerly 31 CFR 103.11(n)).

With Crypto, Congress, Not Agencies, Should Decide What's Next

spectator.org/crypto-regulations-congress/

By Andrew Langer April 26, 2021

As China rolls out its digital currency, it's past time for action.
April 26, 2021, 12:11 PM

Alongside the public's newly found fascination with cryptocurrencies (which only sometimes includes their attempts to try and understand what they are — a process for the teacher akin to trying to explain to an AARP member how to program a VCR back in the day), there is serious debate and discussion among scholars and policymakers about how to look at them and treat them for public policy purposes.

From a public policy perspective, the question centers essentially on assigning "crypto" to one of four different categories. Are they

- Securities? Are they a tradeable "financial instrument" that create some kind of ownership right?
- Commodities? Are they some kind of raw material gained through a resource-intensive extraction process?
- Currencies? Are they some kind of unit of exchange backed by some kind of hard asset?

- Something different entirely, requiring a whole new vocabulary or public policy approach?

All are being considered, and each approach has its adherents and detractors.

The most logical route would be to view cryptocurrency as an entirely new thing (which it is). It doesn't easily fit into any of the preexisting categories — it's somewhere, honestly, between a commodity and a currency. Many cryptocurrencies do require intense resource utilization, but they can immediately be used as a standard of exchange.

But politics and public policy rarely follow the path of logic. Expedience is usually the solution to the question of the day — so policymakers will most likely try (and are trying) to fit crypto into one of those preexisting categories.

Of course, policymakers could leave crypto alone entirely. After all, that's part of what cryptocurrencies are there for: to be used as an investment or transaction medium just out of reach of government hands or eyes. But that's highly unlikely given the enormous value of the crypto marketplace — over $1 trillion by some estimates. Policymakers, especially those on the revenue-hungry and tax-producing left, want their cut, and that will require some decision-making — and leadership on someone's part.

In the United States, that leadership *should* come from Congress, well before any action on the part of executive branch agencies, especially since nobody has decided just what a cryptocurrency is. But sometimes the president doesn't want to wait for Congress, and sometimes agency heads don't want to wait for the White House, to make those kinds of decisions.

Part of the problem, of course, is that the vagueness of existing statutory regimes gives agencies enormous power, and deference in deciding how that power is used. Under the concept of "Chevron Deference," an agency has enormous leeway in how it interprets the statutes undergirding its powers. Under the concept of "Auer Deference," that same agency has enormous leeway in how it interprets the regulations it has properly promulgated.

This leads us to a real problem within the public policy arena when it comes to cryptocurrency. In the last days of the previous administration, and on the very last day of his tenure as head of the Securities and Exchange Commission, SEC Chair Jay Clayton oversaw the filing of a lawsuit against Ripple, the creator of the cryptocurrency XRP.

Despite having said in 2018 that Bitcoin (probably the best-known cryptocurrency) was *not* a "security" (as that term is defined for the scope of the SEC's authority), Clayton decided that this late-in-the-day suit against Ripple was warranted. Similarly curious, the SEC's Corporation Finance Division Chief William Hinman also said in a widely covered 2018 speech that cryptocurrencies like Ether were also *not* securities under the regulatory auspices of the SEC.

While it is unclear what changed between these public statements and the SEC's decision to put the full weight of federal law enforcement actions in a lawsuit against Ripple, what is clear is that the lawsuit has had a profound impact on that company, which is now facing scrutiny for more than seven years of trading in that cryptocurrency. But it had an even worse impact on millions of retail holders of XRP, who have traded it as a currency, not a security, for the same length of time. The investors, which the SEC is supposed to be protecting, faced the loss of current trading on platforms like Coinbase, which suspended such trades in the wake of the SEC's suit.

This is especially important given what both Clayton and Hinman were doing before they came to the highest levels of the SEC and what they've been doing since they left public service. Clayton works for One River Digital Asset Management, an investment hedge fund focused exclusively on the two cryptocurrencies he helped at the SEC — Bitcoin and Ether. Hinman has gone back to the venerated, white-shoe law firm of Simpson Thacher & Bartlett. Simpson Thacher is part of the Enterprise Ethereum Alliance, an entity that looks at the uses of Ethereum's blockchain technologies beyond just the cryptocurrency side. (Blockchain, the distributing ledgering system underlying cryptocurrencies, sometimes is used to create cryptocurrencies in and of themselves, and sometimes they use cryptocurrencies to create tokens that incentivize the distributed security responsibilities of a blockchain-based ledger.)

But it's Clayton and Hinman's work with China that should be especially concerning. It is the "prime directive" of the Chinese Communist Party to replace the United States as the dominant global power, both in terms of raw strength and, especially, economic power. This has come in the form of undercutting U.S. manufacturing costs, ignoring global environmental regimes, investing heavily in infrastructure in developing economies, and, unsurprisingly, developing cryptocurrency. China has released its own version of a digital currency, with the clear goal of making the yuan — both in its hard and digital forms, the preeminent global currency.

Clayton and Hinman have both done high-level work for Chinese firms. Both, for instance, were signatories to the filings with the SEC in the IPO for marketplace giant Alibaba. And in addition to China's creation of a digital yuan, the nation has become a major player in the crypto marketplace, having focused on massively scaling up the nation's ability to "mine" Bitcoin. Some theorize that China effectively controls the Bitcoin marketplace, with some two-thirds of the total global mining capacity.

Beyond being threatened by large-scale Bitcoin mining elsewhere, the one thing that would concern the Chinese government is competition from other cryptocurrencies — currencies like XRP. By taking government action and effectively tying up the trading of XRP, those who control the mining of Bitcoin and Ether could benefit enormously.

Importantly, the chain of agency decision-making, and the inconsistencies between the lawsuit and the public statements of Clayton and Hinman regarding the federal treatment of crypto, isn't lost on the judge assigned to the SEC's lawsuit. Magistrate Judge Sarah Netburn, who sits in the federal bench's Southern District of New York, said that the statements these officials made about Bitcoin and Ether are highly relevant in the lawsuit against Ripple and XRP, and she gave Ripple the green light to access internal documents that shed light on how those impactful public comments came about.

Regardless of the outcome of the Ripple case, it is clear that the SEC, Clayton, and Hinman should not have hijacked the policy process by taking advantage of a vacuum of clear boundaries on how far agencies can stick their noses into these issues. This is especially true given the competitive economic interests in question. While the U.S. is hamstringing the world's best cryptocurrency creators with legal and regulatory proceedings, China is rocketing ahead with a digital currency of its own by ripping off the innovations of others and is working to effectively control cryptocurrency marketplaces by mining blockchains that started in the free world.

While past experience certainly indicates that Congress will not likely act in a beneficial way, the time has come for them to take a smart look at crypto and make a logical decision about how to treat it for policy purposes. They can start by putting clear limits on the regulators. It's not that crypto is the next global economic battlefield — it's the current one.

Andrew Langer is President of the Institute for Liberty and has worked on cryptocurrency and blockchain policy issues for several years.

Tab 47 – Coinbase Wallet Review

Please see the following link for the full video:
https://video.search.yahoo.com/search/video?fr=mcafee&ei=UTF-8&p=coinbase+wallet&type=E211US105G0#id=2&vid=3793d669a8319cfdd9f603ac2a56810c&action=view

7 U.S. Code § 6c - Prohibited transactions

U.S. Code Notes

(a) In general

(1) Prohibition

It shall be unlawful for any person to offer to enter into, enter into, or confirm the execution of a transaction described in paragraph (2) involving the purchase or sale of any commodity for future delivery (or any option on such a transaction or option on a commodity) or swap if the transaction is used or may be used to—

(A) hedge any transaction in interstate commerce in the commodity or the product or byproduct of the commodity;

(B) determine the price basis of any such transaction in interstate commerce in the commodity; or

(C) deliver any such commodity sold, shipped, or received in interstate commerce for the execution of the transaction.

(2) Transaction

A transaction referred to in paragraph (1) is a transaction that—

(A)

(i) is, of the character of, or is commonly known to the trade as, a "wash sale" or "accommodation trade"; or

(ii) is a fictitious sale; or

(B) is used to cause any price to be reported, registered, or recorded that is not a true and bona fide price.

(3) Contract of sale

It shall be unlawful for any employee or agent of any department or agency of the Federal Government or any Member of Congress or employee of Congress (as such terms are defined under section 2 of the STOCK Act) or any judicial officer or judicial employee (as such terms are defined, respectively, under section 2 of the STOCK Act) who, by virtue of the employment or position of the Member, officer, employee or agent, acquires information that may affect or tend to affect the price of any commodity in interstate commerce, or for future delivery, or any swap, and which information has not been disseminated by the department or agency of the Federal Government holding or creating the information or by Congress or by the judiciary in a manner which makes it generally available to the trading public, or disclosed in a criminal, civil, or administrative hearing, or in a congressional, administrative, or Government Accountability Office report, hearing, audit, or investigation, to use the information in his personal capacity and for personal gain to enter into, or offer to enter into—

(A) a contract of sale of a commodity for future delivery (or option on such a contract);

(B) an option (other than an option executed or traded on a national securities exchange registered pursuant to section 78f(a) of title 15); or

(C) a swap.

(4) Nonpublic information

(A) Imparting of nonpublic information

It shall be unlawful for any employee or agent of any department or agency of the Federal Government or any Member of Congress or employee of Congress or any judicial officer or judicial employee who, by virtue of the employment or position of the Member, officer, employee or agent, acquires information that may affect or tend to affect the price of any commodity in interstate commerce, or for future delivery, or any swap, and which information has not been disseminated by the department or agency of the Federal Government holding or creating the information or by Congress or by the judiciary in a manner which makes it generally available to the trading public, or disclosed in a criminal, civil, or administrative hearing, or in a congressional, administrative, or Government Accountability Office report, hearing, audit, or investigation, to impart the information in his personal capacity and for personal gain with intent to assist another person, directly or indirectly, to use the information to enter into, or offer to enter into—

(i) a contract of sale of a commodity for future delivery (or option on such a contract);

(ii) an option (other than an option executed or traded on a national securities exchange registered pursuant to section 78f(a) of title 15); or

(iii) a swap.

(B) Knowing use

It shall be unlawful for any person who receives information imparted by any employee or agent of any department or agency of the Federal Government or any Member of Congress or employee of Congress or any judicial officer or judicial employee as described in subparagraph (A) to knowingly use such information to enter into, or offer to enter into—

(i) a contract of sale of a commodity for future delivery (or option on such a contract);

(ii) an option (other than an option executed or traded on a national securities exchange registered pursuant to section 78f(a) of title 15); or

(iii) a swap.

(C) Theft of nonpublic information

It shall be unlawful for any person to steal, convert, or misappropriate, by any means whatsoever, information held or created by any department or agency of the Federal Government or by Congress or by the judiciary that may affect or tend to affect the price of any commodity in interstate commerce, or for future delivery, or any swap, where such person knows, or acts in reckless disregard of the fact, that such information has not been disseminated by the department or agency of the Federal Government holding or creating the information or by Congress or by the judiciary in a manner which makes it generally available to the trading public, or disclosed in a criminal, civil, or administrative hearing, or in a congressional, administrative, or Government Accountability Office report, hearing, audit, or investigation, and to use such information, or to impart such information with the intent to assist another person, directly or indirectly, to use such information to enter into, or offer to enter into—

(i) a contract of sale of a commodity for future delivery (or option on such a contract);

(ii) an option (other than an option executed or traded on a national securities exchange registered pursuant to section 78f(a) of title 15); or

(iii) a swap, provided, however, that nothing in this subparagraph shall preclude a person that has provided information concerning, or generated by, the person, its operations or activities, to any employee or agent of any department or agency of the Federal Government, to Congress, any Member of Congress, any employee of Congress, any judicial officer, or any judicial employee, voluntarily or as required by law, from using such information to enter into, or offer to enter into, a contract of sale, option, or swap described in clauses [1] (i), (ii), or (iii).

(5) Disruptive practices

It shall be unlawful for any person to engage in any trading, practice, or conduct on or subject to the rules of a registered entity that—

(A) violates bids or offers;

(B) demonstrates intentional or reckless disregard for the orderly execution of transactions during the closing period; or

(C) is, is of the character of, or is commonly known to the trade as, "spoofing" (bidding or offering with the intent to cancel the bid or offer before execution).

(6) Rulemaking authority
The Commission may make and promulgate such rules and regulations as, in the judgment of the Commission, are reasonably necessary to prohibit the trading practices described in paragraph (5) and any other trading practice that is disruptive of fair and equitable trading.

(7) Use of swaps to defraud
It shall be unlawful for any person to enter into a swap knowing, or acting in reckless disregard of the fact, that its counterparty will use the swap as part of a device, scheme, or artifice to defraud any third party.

(b) Regulated option trading
No person shall offer to enter into, enter into or confirm the execution of, any transaction involving any commodity regulated under this chapter which is of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty", contrary to any rule, regulation, or order of the Commission prohibiting any such transaction or allowing any such transaction under such terms and conditions as the Commission shall prescribe. Any such order, rule, or regulation may be made only after notice and opportunity for hearing, and the Commission may set different terms and conditions for different markets.

(c) Regulations for elimination of pilot status of commodity option transactions; terms and conditions of options trading

Not later than 90 days after November 10, 1986, the Commission shall issue regulations—

(1) to eliminate the pilot status of its program for commodity option transactions involving the trading of options on contract markets, including any numerical restrictions on the number of commodities or option contracts for which a contract market may be designated; and

(2) otherwise to continue to permit the trading of such commodity options under such terms and conditions that the Commission from time to time may prescribe.

(d) Dealer options exempt from subsections (b) and (c) prohibitions; requirements

Notwithstanding the provisions of subsection (c) of this section—

(1) any person domiciled in the United States who on May 1, 1978, was in the business of granting an option on a physical commodity, other than a commodity specifically set forth in section 2(a) of this title prior to October 23, 1974, and was in the business of buying, selling, producing, or otherwise using that commodity, may continue to grant or issue options on that commodity in accordance with Commission regulations in effect on August 17, 1978, until thirty days after the effective date of regulations issued by the Commission under clause (2) of this subsection: Provided, That if such person files an application for registration under the regulations issued under clause (2) of this subsection within thirty days after the effective date of such regulations, that person may continue to grant or issue options pending a final determination by the Commission on the application; and

(2) the Commission shall issue regulations that permit grantors and futures commission merchants to offer to enter into, enter into, or confirm the execution of, any commodity option transaction on a physical commodity subject to the provisions of subsection (b) of this section, other than a commodity specifically set forth in section 2(a) of this title prior to October 23, 1974, if—

(A) the grantor is a person domiciled in the United States who—

(i) is in the business of buying, selling, producing, or otherwise using the underlying commodity;

(ii) at all times has a net worth of at least $5,000,000 certified annually by an independent public accountant using generally accepted accounting principles;

(iii) notifies the Commission and every futures commission merchant offering the grantor's option if the grantor knows or has reason to believe that the grantor's net worth has fallen below $5,000,000;

(iv) segregates daily, exclusively for the benefit of purchasers, money, exempted securities (within the meaning of section 78c(a)(12) of title 15), commercial paper, bankers' acceptances, commercial bills, or unencumbered warehouse receipts, equal to an amount by which the value of each transaction exceeds the amount received or to be received by the grantor for such transaction;

(v) provides an identification number for each transaction; and

(vi) provides confirmation of all orders for such transactions executed, including the execution price and a transaction identification number;

(B) the futures commission merchant is a person who—

(i) has evidence that the grantor meets the requirements specified in subclause (A) of this clause;

(ii) treats and deals with all money, securities, or property received from its customers as payment of the purchase price in connection with such transactions, as belonging to such customers until the expiration of the term of the option, or, if the customer exercises the option, until all rights of the customer under the commodity option transaction have been fulfilled;

(iii) records each transaction in its customer's name by the transaction identification number provided by the grantor;

(iv) provides a disclosure statement to its customers, under regulations of the Commission, that discloses, among other things, all costs, including any markups or commissions involved in such transaction; and

(C) the grantor and futures commission merchant comply with any additional uniform and reasonable terms and conditions the

Commission may prescribe, including registration with the Commission.

The Commission may permit persons not domiciled in the United States to grant options under this subsection, other than options on a commodity specifically set forth in section 2(a) of this title prior to October 23, 1974, under such additional rules, regulations, and orders as the Commission may adopt to provide protection to purchasers that are substantially the equivalent of those applicable to grantors domiciled in the United States. The Commission may terminate the right of any person to grant, offer, or sell options under this subsection only after a hearing, including a finding that the continuation of such right is contrary to the public interest: *Provided*, That pending the completion of such termination proceedings, the Commission may suspend the right to grant, offer, or sell options of any person whose activities in the Commission's judgment present a substantial risk to the public interest.

(e) Rules and regulations

The Commission may adopt rules and regulations, after public notice and opportunity for a hearing on the record, prohibiting the granting, issuance, or sale of options permitted under subsection (d) of this section if the Commission determines that such options are contrary to the public interest.

(f) Nonapplicability to foreign currency options

Nothing in this chapter shall be deemed to govern or in any way be applicable to any transaction in an option on foreign currency traded on a national securities exchange.

(g) Oral orders

The Commission shall adopt rules requiring that a contemporaneous written record be made, as practicable, of all orders for execution on the floor or subject to the rules of each contract market or derivatives transaction execution facility placed by a member of the contract market or derivatives transaction execution facility who is present on the floor at the time such order is placed.

(Sept. 21, 1922, ch. 369, § 4c, as added June 15, 1936, ch. 545, § 5, 49 Stat. 1494; amended Pub. L. 93–463, title I, § 103(a), title IV, § 402, Oct. 23, 1974, 88 Stat. 1392, 1412; Pub. L. 95–405, § 3, Sept. 30, 1978, 92

Stat. 867; Pub. L. 97–444, title I, § 102, title II, § 206, Jan. 11, 1983, 96 Stat. 2296, 2301; Pub. L. 99–641, title I, § 102, Nov. 10, 1986, 100 Stat. 3557; Pub. L. 102–546, title II, § 203(a), title IV, § 402(4), Oct. 28, 1992, 106 Stat. 3600, 3624; Pub. L. 106–554, § 1(a)(5) [title I, §§ 109, 123(a)(6)], Dec. 21, 2000, 114 Stat. 2763, 2763A–383, 2763A–407; Pub. L. 111–203, title VII, §§ 741(b)(2), 746, 747, July 21, 2010, 124 Stat. 1731, 1737, 1739; Pub. L. 112–105, § 5, Apr. 4, 2012, 126 Stat. 293.)