

Insights: Alerts

Recent Enforcement Action Provides Helpful Guidance in Several Areas for Advisers to Private Funds

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In April and May 2020, the Securities and Exchange Commission (the “Commission”) entered a series of settled Orders assessing fines, instituting a bar, and ordering remedial action against registered investment advisers (“RIAs”) and/or their principals for conduct relating to fee and conflicts disclosures, charging performance-based fees, advertising (including the use of testimonials and performance information), trading on material non-public information (“MNPI”) and the custody rule.¹

While the underlying topics have long been areas of focus, these actions provide a fresh look at the Enforcement Division's current approach to these issues, including its willingness to bring cases for what industry participants might view as stale and/or “technical” violations (*i.e.*, events from many years ago or instances where there was no clear client nor market harm).

This Alert summarizes six Orders, including take-aways from each:²

1. [A private equity fund adviser was fined \\$200,000 and ordered to pay \\$2 million in disgorgement for failing to properly disclose conflicts relating to receipt of fees/reimbursement from portfolio companies owned by private equity funds that it managed.](#)
2. [An adviser to pooled investment vehicles was fined \\$750,000 and ordered to pay \\$2.5 million in disgorgement for making an investment that was arguably contrary to some statements in the fund's offering materials and inaccurately describing that investment in monthly presentations to fund investors.](#)
3. [A state-registered investment adviser to separately managed accounts \(“SMAs”\) and private funds was fined for charging performance-based fees to non-qualified investors in the private funds.](#)
4. [A RIA and affiliated persons and entities were each subject to fines and statutory disqualification for publishing and distributing misleading advertising materials \(including testimonials and hypothetical performance information\).](#)
5. [A private funds adviser was fined \\$60,000 for failing to fully and timely comply with the Audited Financials Alternative of the custody rule.](#)
6. [A large RIA was fined \\$1 million for failing to establish and/or to enforce policies and procedures to prevent misuse of MNPI when buying and selling shares of a portfolio company where the adviser's](#)

representative sat on the company's board.

1. Disclosures re Services Provided to Portfolio Company by Adviser to PE Fund

On April 22, 2020, the Commission found that Monomoy Capital Management, L.P. (“Monomoy”), a private equity fund adviser, violated Sections 206(2)³ of the Investment Advisers Act of 1940, as amended (“Advisers Act”) and imposed a \$200,000 fine and ordered nearly \$2 million in disgorgement (including interest). The conduct at issue occurred between April 2012 and December 2016.

The Commission concluded that Monomoy failed to adequately disclose fees that it charged portfolio companies held by private equity funds that it managed⁴; the fees (sometimes fashioned as reimbursements) related to operational and “business improvement” services provided by Monomoy to the portfolio companies.

The Commission found that marketing materials used to raise investments for Monomoy's second private equity fund⁵ touted its provision of operational services to portfolio companies as something done to enhance value and generate better investment returns for the fund (rather than as a separate source of revenue in the form of fees collected for providing those services). The reimbursements/fee assessments from the portfolio companies represented 13.3% of all revenue Monomoy received with respect to its management of this fund. The Order further noted that Monomoy failed to properly disclose to prospective investors in the fund the conflicts of interest posed by Monomoy providing operational services for a fee to portfolio companies owned by the fund.

The limited partnership agreement relative to this fund disclosed that portfolio companies were responsible for paying Monomoy certain fees, including “closing fees, investment banking fees, placement fees, monitoring fees, consulting fees, directors fees and other similar fees.” The Commission concluded that this disclosure was not sufficiently specific to enable investors to understand the conflict of interest(s) posed nor to have a basis upon which they could “consent to or reject this practice.”

Furthermore, beginning in March 2014, Monomoy's Form ADV disclosed that Monomoy may provide portfolio companies services that other third parties might typically perform and that Monomoy may be reimbursed for costs related to such services. However, the Commission found that Monomoy routinely provided such services and was routinely paid/reimbursed for such services.⁶

Take-Aways

The Enforcement Division remains laser focused on, and suspicious of, the use of “may” in disclosure documents. If something will happen at least some of the time, then saying that it “may” happen is likely to be considered misleading. Revising disclosure documents requires more than finding and replacing the word “may.” When replacing a “may” disclosure, advisers should consider whether it is appropriate to add a sentence or two that explains what it knows and does not know about the specific circumstances that give rise to a specific disclosure.

The Commission seems to be continuously raising its expectations for specificity within disclosure documents, both for the adviser and governing documents relative to private funds. Advisers and private funds should consider conducting a holistic review of offering materials and disclosure documents to determine whether revisions are necessary to align with the

Commission's current expectations. This is especially true for any RIAs that have not been examined by OCIE for several years.

When conflicts disclosures are amended within the Form ADV Part 2 brochure, careful consideration should be given to whether that disclosure warrants inclusion in the Material Changes section. When in doubt, include it.

The Commission can and will take action relative to registrants even when the adviser's conduct did not result in any client or market harm.

2. Private Placement Memorandum Disclosures

On April 30, 2020, the Commission found that Everest Capital LLC, an adviser to pooled investment vehicles, and its principal (collectively, "Everest"), violated Sections 206(2) and 206(4)⁷ of the Advisers Act, as well as Rule 206(4)-8⁸, and imposed a monetary penalty of \$750,000 and ordered nearly \$2.5 million in disgorgement (including interest).

The Commission concluded that Everest had managed the Everest Capital Global Fund, L.P. (the "Fund") inconsistently with disclosures made regarding investment concentration and risk controls in the private offering memorandum (the "POM") for the Fund.⁹

The conduct at issue occurred between September 4, 2014 and January 15, 2015; Everest withdrew its registration as an RIA on February 26, 2016. This is indicative of the Commission's willingness to continue to pursue cases against defunct advisers relative to conduct more than five years old (and by extension, the Enforcement Division's continued reliance on tolling agreements, SCOTUS rebukes notwithstanding.¹⁰).

The POM distributed to prospective Fund investors stated that the Fund invested "principally in equities," would not take concentrated positions in any specific region, and had in place a risk management team empowered to act unilaterally to reduce risk independent of the investment team's actions. Everest represented that its investing strategy was informed by lessons learned in 1998, when the Fund sustained substantial losses due to highly concentrated positions in Russian investments. The POM also included broad disclaimers, e.g., that investors should be prepared to bear "the loss of their entire investment" and that there were "no restrictions on the Fund's use of leverage other than restrictions which may be imposed by lenders from time to time."

Everest took a highly concentrated position in a euro to Swiss franc exchange, which caused the Fund's gross exposure in the EUR/CHF position to be between 400% and 900%, bringing the Fund's overall leverage to as much as 1300%. Additionally, the risk management team had no ability to reduce risk relative to the EUR/CHF currency position.

Everest had internal risk grids and protocols (that were the basis for the statements in the POM), however, these grids and protocols did not relate to currency trades, and as such currency trades were not subject to risk monitoring, risk limits, risk review, nor automatic, independent risk reduction measures. Everest did not disclose that currency trades were excluded from its internal risk grids and protocols.¹¹

Everest also distributed written, monthly presentations to current and prospective investors that included misstatements about the Fund's gross exposure because the figures excluded currency positions, including the EUR/CHF position, and did not disclose such exclusion.¹² The Commission pointed to these presentations as

its basis for concluding that Everest mislead Fund investors regarding its highly concentrated position relative to a specific region (*i.e.*, Switzerland) (which the POM said it would not do) and the potential risk posed by that position.

When the franc moved against the euro, the highly levered, single EUR/CHF currency position caused the Fund to incur losses that exceeded its total assets, forcing closure of the Fund.

Take-Aways

There are limited requirements regarding what disclosures or statements an adviser to a pooled investment vehicle must make to investors in that fund; but every statement must be accurate and not misleading. More simply stated: You don't have to say much, but anything you say better be entirely accurate and complete.

Statements in offering materials such as “investors should be prepared to lose their entire investment” will not inoculate against regulatory action for losses that result from conduct that is otherwise inconsistent with representations made to investors in the fund.

To be effective, risk management processes should address all products and strategies utilized by an adviser in managing a fund's assets and not just those most often utilized. This requires regularly re-assessing processes in light of any changes to products, strategies, or models utilized by the adviser.

3. Assessing Performance-based Fees from Accredited but not Qualified Clients

On May 14, 2020, the Texas State Securities Board (“Board”) entered an order reprimanding and fining Lorintine Capital, LP (“Lorintine”), a state registered investment adviser¹³ to more than 250 SMAs and two private funds; about one-third of the SMA clients were also invested in at least one of the funds, including LC Diversified Fund 1 (“Fund 1”), which was established by Lorintine. The Board concluded that Lorintine violated Section 116.1 *Advisory Fee Requirements*¹⁴, and Section 116.10 *Supervisory Requirements* of the Board Rules.¹⁵

The private placement memorandum and subscription agreement for Fund 1 disclosed to investors that they would be charged an annual management fee equal to one percent of the value of their position in the fund, and a 10% performance fee. Texas state law, and federal law,¹⁶ only allows advisers to charge performance fees to certain types of clients (*e.g.*, “qualified clients”). In Texas, the designation of a “qualified” client is a significantly higher threshold than that of an accredited investor. However, Lorintine's processes for confirming investors' status was limited to confirming that the investor met accredited standard (but not whether the client met the definition of a qualified client). The Board determined that Lorintine received \$2,845.45 in performance fees from five non-qualified clients.

While the fine amount was modest (\$10,000), Lorintine will now be required to report the regulatory action taken against it on its Form ADV Parts 1 and 2, and could face further inquiry from its regulators in other states.

Take-Away

Whether subject to federal or state regulation, when structuring subscription documents for a private fund, it is critical to understand an investor's status and only assess performance fees to

qualified clients. It is also important to have a written policy explaining the adviser's process in determining and verifying whether an investor is a qualified client or accredited investor and maintaining documentation that evidences implementation and compliance with such process.

4. Misleading Advertising (including, testimonials and hypothetical performance)

On May 1, 2020, the Commission entered an Order against a RIA and several related entities and parties for violations of Section 10b of the Securities Exchange Act of 1934, as amended ("Exchange Act"), Rule 10b-5 of the Exchange Act, and Sections 206(1) and 206(2) of the Advisers Act following the use of inaccurate performance data and testimonials in advertising materials. Respondent Kirkland, the RIA, was barred, each natural person respondent was fined \$40,000, and all respondents were ordered to cease-and desist future violations. As a result of the statutory violations set out in the Order, all will now be treated as a "bad actor" under various provisions of the federal and state's securities laws including the safe harbor provision of Regulation D (unless and until a waiver from such classification is obtained).

Kirkland acted as an investment adviser by selling a subscription service for options trading signals that her clients could use to trade. Davis managed all aspects of the service through his company, which fulfilled and administered the subscriptions as well as generated trade signals with Kirkland's input. Schmidt provided the platform to market and sell subscriptions through his company but he never interfaced with clients nor created the performance track records used to promote Kirkland's services. Kirkland, Davis and Schmidt shared the profits from the subscription services.

Marketing materials for the subscription service touted an "83% win-rate," annual returns of 910%, and Kirkland's personal success using the underlying strategy to make millions. The Commission found that Kirkland and Davis knew, or were reckless in not knowing, that their claims were false and misleading because: (1) investors complained that their accounts produced substantially lower success rates than advertised; and (2) the performance results were based on hypothetical data and signal parameters selected in hindsight, which they marketed as the entire historical records, and produced artificially strong performance.

Marketing materials also used testimonials that were falsely presented as relating to one subscription service when they related to a different service offered in the past. Testimonials were used after the clients who provided the statements expressly asked that they be removed given trading losses incurred by those clients.¹⁸

Schmidt was held responsible for incorporating the false and misleading claims, performance results, and testimonials without verifying their accuracy.

Take-Aways

When using performance data in marketing materials, RIAs must fully disclose the basis and methodology on how the RIA generated the performance results to investors and potential investors. Disclosure can be more difficult when using hypothetical, back-tested data to generate performance results.

When using model performance in advertising, the Commission will consider a number of factors when examining whether such performance is fraudulent or misleading, including, but not limited to, the limitations inherent in the model, any material changes in the model, the relationship to actual services, and whether the actual results are materially different.¹⁹

Receiving information from others does not alleviate a person's responsibility to ensure any statements made in the provision of investment advice and/or offer or sale of a security is accurate and complete.

Orders with seemingly modest sanctions (e.g., a fine of \$40,000) can nonetheless carry extraordinary collateral consequences in the form of statutory disqualification depending on the regulations that a respondent is found to have violated.

5. The Audited Financials Alternative of the Custody Rule

On April 22, 2020, the Commission censured TSP Capital Management Group, LLC, ("TSP"), a private fund adviser, for violating Section 206(4) of the Advisers Act and Rules 206(4)-2 (the "Custody Rule")²⁰ and 206(4)-7, and imposed a \$60,000 fine. The conduct at issue occurred between 2014 and 2018.

The Commission found that TSP violated the Custody Rule by failing to provide annual audited financial statements to investors of a private fund it advised and violated Rule 206(4)-7 for failing to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act.

The Order notes that TSP apparently intended to rely on an alternative method for complying with the Custody Rule that is available to advisers to limited partnerships or other types of pooled investment vehicles as provided under Rule 206(4)-2(b)(4), namely the Audited Financials Alternative. Specifically, the Order describes a pattern of TSP making various attempts at compliance but ultimately failing to comply with or to timely comply with the requirement that a PCAOB-registered firm conduct an annual audit and that the resulting financial statements from those audits be delivered to fund investors within 120 days of the end of the fiscal year. TSP repeatedly mailed the fund's audited financials hundreds of days late or failed to do so entirely.

Take-Aways

The Custody Rule is a consistent, recurring topic in OCIE examinations; it is often flagged in post examination deficiency letters, and is often misunderstood by RIAs.

Advisers should consider conducting a holistic review of their business model(s) and accounts to affirm that they understand and are complying with all applicable aspects of the Custody Rule (including surprise exams, auditor requirements, and inadvertent custody).

Technical violations, even in the absence of client harm or malfeasance by the RIA, can still result in a registrant having to engage in the resource-intensive process of responding to a regulatory enforcement matter. The fine amount assessed likely pales in comparison to the legal costs, employee time, and strain associated with responding to the inquiry, as well as the reputational ramifications for the adviser resulting from a public, formal order reportable on its Form ADV.

6. Ineffective Policies and Procedures to Prevent Misuse of Material Non-Public Information

On May 26, 2020, the Commission found that Ares Management LLC, ("Ares") violated Sections 204A and 206(4)-7 of the Advisers Act and assessed a \$1 million fine for having failed to "establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of such investment adviser's business, to prevent the misuse of material, nonpublic information by" Ares or any person associated

with Ares. The primary conduct that gave rise to the action occurred in 2016. The Enforcement Division commenced its investigation in 2019.²¹

Ares is a global alternative asset manager with more than \$149 billion in AUM across credit, private equity, and real estate asset groups; its clients include pooled investment vehicles (both public and private funds) and SMAs.

As detailed in the Order, Ares had extensive policies and procedures regarding MNPI, including maintenance of a restricted list, processes for the compliance team's review of trading relative to securities on the restricted list and documentation regarding that review, and systematic hard blocks within its order entry system tied to the restricted list.

Notwithstanding, the Commission concluded that the implementation of the policies was "left to the discretion of Ares' compliance staff" resulting in inconsistent implementation, insufficient documentation and ambiguity.²²

The Commission also found that Ares' policies and procedures did not address issues specific to an Ares representative having a dual role as a director of a publically-traded portfolio company and as an Ares employee, particularly where that person remained involved in Ares' trading decisions regarding the portfolio company's stock. This apparently resulted from Ares personnel previously having not commonly held seats on the board of publicly-listed companies.

The Ares Order dedicates a lengthy paragraph to explaining the impressive efforts voluntarily undertaken by Ares to cure its compliance oversights, including retention of an outside consultant to review and revise its policies, procedures, and supervisory system regarding handling of MNPI, enhanced training programs, and cooperation with the Commission's staff. These efforts may explain why the Commission determined it appropriate to use its discretion to agree to a settled resolution with relatively benign legal conclusions in an Order that carries no apparent collateral consequences, names only the firm, and keeps anonymous the identities of all individuals involved.

Take-Aways

Effective policies and procedures and a reasonably designed supervisory system must also include comprehensive training, and a system designed to test whether the procedures are being effectively and consistently implemented. Training and testing should occur at a regular, ongoing interval.

Registrants should create and retain documentation evidencing consistent compliance with the firm's policies and procedures, especially when a policy includes a requirement to conduct and document a review. An inability to evidence through specific, contemporaneous documentation that a procedure was followed may be treated as evidence of non-compliance by the Enforcement Division's staff.

All aspects of policies and procedures, including those relating to MNPI, require regular review to determine whether changes in the adviser's business activities necessitates changes or enhancements to its policies (e.g., an adviser representative has a dual role that leads the adviser to owe a fiduciary duty to different parties, such as shareholders of a public company vis-a-vie the

representative's role as a company director, and clients of the adviser on whose behalf the adviser makes trading decisions).

Prompt remediation and strategic cooperation from the outset of an Enforcement Division investigation often leads to better, less damaging disciplinary outcomes. Engaging experienced regulatory enforcement counsel early on can pay dividends in the long run.

Footnotes

¹Our experience in representing clients in responding to the Office of Compliance Inspection and Examinations (“OCIE”) and Enforcement Division matters continuously shows that (1) the Commission’s staff (“Staff”) sometimes asserts a view of regulatory requirements that is different (often broader, more specific, or more onerous) than the text of the underlying rule/regulation and official guidance (e.g., adopting releases, court decisions) relating to the same; and (2) settled Orders are written by and from the perspective of the Staff (not the Respondent) and as such may lack important context, nuance or mitigating factors. Notwithstanding these limitations, we nonetheless consider the substance of the Orders described herein instructive for registrants seeking to assess, and where appropriate enhance, their compliance programs in light of best practices and what seems to be the current expectations of the Staff.

²All but one Order was entered by the Commission; there is also a recent case out of Texas that is instructive for both federally- and state-registered advisers.

³The legal standard for a violation of Section 206(2) is merely negligence; the adviser can be held responsible even if the adviser does not knowingly nor intentionally mislead investors.

⁴While not expressly stated in the Order, it is implied that Monomoy initially utilized its management fee to cover the costs of providing these services to portfolio companies, and only later commenced separately assessing fees from the portfolio companies. It appears that the Commission concluded that disclosures were not timely nor sufficiently updated when this change in business practices occurred.

⁵Investors (*a.k.a.*, limited partners) in this fund include pension funds, public employee retirement systems, charities, institutional investors and high net worth individuals.

⁶The Order notes that the Material Changes section of the amended March 2014 brochure did not identify this new disclosure. The implication of this statement is that the disclosure should have been highlighted in the Material Changes section.

⁷The legal standard for a finding under Section 206(4) is merely negligence; the adviser can be held responsible even if the adviser does not knowingly nor intentionally mislead investors.

⁸Even though, technically, the fund is the adviser’s only client (and the investors in the fund are not the adviser’s clients), Rule 206(4)-8(a) makes it unlawful for an adviser to a fund (*a.k.a.*, a pooled investment vehicle) to make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle. The rule was promulgated following the SCOTUS’ decision in *Goldstein v. Securities and Exchange Commission*, 451 F.3d 873 (2006).

⁹At its peak, the Fund had approximately \$830 million in assets under management (“AUM”); Everest managed pooled investment vehicles, including but not limited to the Fund, with approximately \$3.7 billion in AUM. Everest’s principal was its sole managing member, majority owner, chief investment officer and the Fund’s sole

portfolio manager.

¹⁰See *Gabelli v. Securities and Exchange Commission*, 568 U.S. 442 (2013); see also *Kokesh v. Securities and Exchange Commission*, 137 S. Ct. 1635 (2017).

¹¹It is unclear from the Order whether Everest knew that currency trades were excluded, or if the exclusion was an oversight. The application of a negligence standard suggests the latter.

¹²It is unclear from the Order whether Everest knew that currency trades were excluded from the calculations utilized in preparing the presentations.

¹³Lorintine is registered in Arizona, California, Iowa, Minnesota, South Dakota, and Texas.

¹⁴Section 116.13, *Advisory Fee Requirements*, requires that “(a) Any registered investment adviser who wishes to charge 3.0% or greater of the assets under management must disclose that such fee is in excess of the industry norm and that similar advisory services can be obtained for less” and “(b) Any registered investment adviser who wishes to charge a fee based on a share of the capital gains or the capital appreciation of the funds or any portion of the funds of a client must comply with SEC Rule 205-3 (17 Code of Federal Regulations §275.205-3), which permits the use of such fee if the client is a “qualified client” as defined therein.”

¹⁵Section 116.10, *Supervisory Requirements*, states that “each registered investment adviser shall establish, maintain, and enforce a system to supervise the activities of its investment adviser representatives that is reasonably designed to achieve compliance with the Texas Securities Act, Board rules, and all applicable securities laws and regulations. Supervisory systems must be written and available for inspection in either print or electronic format.”

¹⁶See [Section 275.205-3\(d\)\(1\)](#) of the Advisers Act.

¹⁷In some private offerings, such as a Regulation D Rule 506(b) offering, this can be accomplished by having adequate investor representations. However, in other private offerings, such as a Rule 506(c) offering, a fund cannot merely rely on investor representations, and instead must take reasonable steps to ensure a potential investor is accredited or qualified. Depending on a fund’s size and resources, third party service providers can provide an efficient solution to verification of investors.

¹⁸The Commission’s staff may have declined to include violations of Rule 206(4)-1 because the Commission has proposed changes to the existing prohibition on the use of testimonials (see SEC Proposes to Modernize the Advertising and Cash Solicitation Rules for Investment Advisers, available at <https://www.sec.gov/news/press-release/2019-230>).

¹⁹For a more complete list of factors the SEC will take into account when reviewing model performance in advertising, see Clover Capital Mgmt., Inc., SEC No-Action Letter, 1986 WL 67379 (Oct. 28, 1986) available at <https://www.sec.gov/divisions/investment/noaction/clovercapital102886.htm>.

²⁰[The Custody Rule](#) requires, among other things, that RIAs with custody of client assets to engage an independent public accountant to conduct a surprise examination of such assets, or, if advising a pooled investment vehicle, to distribute the fund’s annual audited financial statements prepared in accordance with GAAP to investors in the fund within 120 days of the end of the fiscal year.

A RIA generally has custody under the Rule if the adviser holds client funds or securities or has any authority to obtain possession of them. This includes, any arrangement (including a general power of attorney) under which the adviser is authorized or permitted to withdraw client funds or securities maintained with a custodian upon the adviser’s instruction to the custodian; and, any capacity (such as general partner of a limited partnership, managing member of a limited liability company or a comparable position for another type of pooled investment vehicle, or trustee of a trust) that gives the adviser legal ownership of or access to client funds or securities

(held in/through the investment vehicle/fund).

²¹In 2016, Ares purchased over 1 million shares of a publicly-traded portfolio company's common stock (where an Ares employee sat on the company's board) in the public market, during open trading windows, following review and approval by Ares' investment committee and compliance personnel. These purchases made up approximately 17% of available or "public float" shares in the portfolio company. During this time, the Ares employee who sat on the board and others Ares employees were in possession of information that was nonpublic and later disclosed by the portfolio company in public company filings made with the Commission and/or press releases. The information related to "(i) potential changes to senior management; (ii) mid-quarter hedging adjustments; (iii) efforts to sell its passive interest in a specific asset; (iv) interest in selling equity and using the proceeds to retire certain debt that had been a source of market concern; and (v) decision to pay quarterly loan interest to Ares "in kind" versus in cash."

²²Quoting from the Order: "[T]he specific manner in which these policies were to be implemented was left to the discretion of Ares' compliance staff. The identification of relevant parties, the manner in which compliance staff followed up with them regarding possession of potential MNPI, and the thoroughness with which MNPI issues were explored with the relevant parties were all largely subject to compliance staff's initiative, discretion, and interpretation. For example, Ares' procedures directed compliance staff to check with the Ares director for potential MNPI but did not expressly require an assessment of whether the director shared information with others or confirmation of the full spectrum of Ares employees who could have acquired the potential MNPI ... As a result, Ares' compliance staff failed to document properly whether they had assessed the extent to which Ares deal team members had any information that had the risk of being MNPI. Moreover, to the extent that compliance staff merely asked the Ares Representative or deal team members if they had potential MNPI, this called for these employees to self-evaluate whether particular information could be 'material' within the context of Ares' policies and for purposes of the federal securities laws." Emphasis added.

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