WINSTON & STRAWN LLP

CLIENT ALERT

By Enforcement, SEC Clarifies Prohibition on Re-Distribution of 144A Securities

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The SEC recently fined[1] Colorado-based investment advisory firm First Western Capital Management Company (FWCM) $200,000 for allegedly purchasing over $666 million in securities over a seven-year period, which were sold in reliance on Rule 144A[2] but were purchased for clients who were not qualified institutional buyers (QIBs). This violated Section 206(4) of the Investment Advisers Act of 1940 (the Advisers Act)[3] and Rule 206(4)–7,[4] which require a registered investment adviser to "[a]dopt and implement written policies and procedures reasonably designed to prevent violation" of the Advisers Act and the rules adopted thereunder.[5] FWCM did not admit or deny the findings in the SEC order, which ordered FWCM to cease and desist from further violations and included a censure and the $200,000 fine.

Rule 144A is a safe-harbor exemption from the registration requirements of Section 5 of the Securities Act of 1933 (the Securities Act).[6] This exemption covers certain offers and sales of qualifying securities by certain persons other than the issuer of the securities. To qualify for the exemption under Rule 144A, the securities must be sold to a QIB, and the securities must be securities that are not listed on a U.S. securities exchange or quoted in a U.S. automated inter-dealer quotation system.

To qualify as a QIB, an institution must own and invest on a discretionary basis at least $100 million in securities of issuers that are not affiliated with the institution, and must be a type of entity specified in Rule 144A. Because a QIB must be an institution, an individual cannot qualify as a QIB, no matter how wealthy or sophisticated.

According to the SEC order, from 2010 through 2017, FWCM "failed reasonably to supervise" its investment adviser representatives (IARs) when it allowed them to purchase more than $666 million in securities—9.4% of FWCM's total securities purchases and repurchases for client accounts—for 81 client accounts. The account holders were not QIBs, but were individuals and trusts, individual retirement accounts, and small institutional accounts that did not meet the QIB asset threshold. FWCM "failed to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder" because it "did not adopt supervisory policies and procedures specifically addressing Rule 144A securities." In particular, FWCM "did not require training for its IARs and supervisors about Rule 144A securities and did not adopt any other process to sufficiently educate them about the Rule 144A products and their accompanying restrictions."

Investment advisers often are tempted to acquire and allocate to their clients securities that are sold pursuant to Rule 144A. This recent enforcement action by the SEC makes clear that advisers who purchase 144A securities on behalf of clients must verify that each such client is a "qualified institutional buyer," and not just an "accredited investor" pursuant to Regulation D under the Securities Act, or a "qualified purchaser" as defined in the Investment Company Act of 1940. This SEC order also highlights the importance of implementing and enforcing a robust compliance program, including both implementing written policies and procedures and adequately training IARs and supervisors to comply with such policies and procedures.

[1] First Western Capital Management Company, Advisers Act Release No. 5543, Administrative Proceeding File No. 3-19882 (July 16, 2020), *available here*.

[2] 17 C.F.R. § 230.144A.

[3] 15 U.S.C. § 80b–6(4).

[4] 17 C.F.R. § 275.206(4)–7.

[5] 17 C.F.R. § 275.206(4)–7(a).

[6] 15 U.S.C. § 77e.

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