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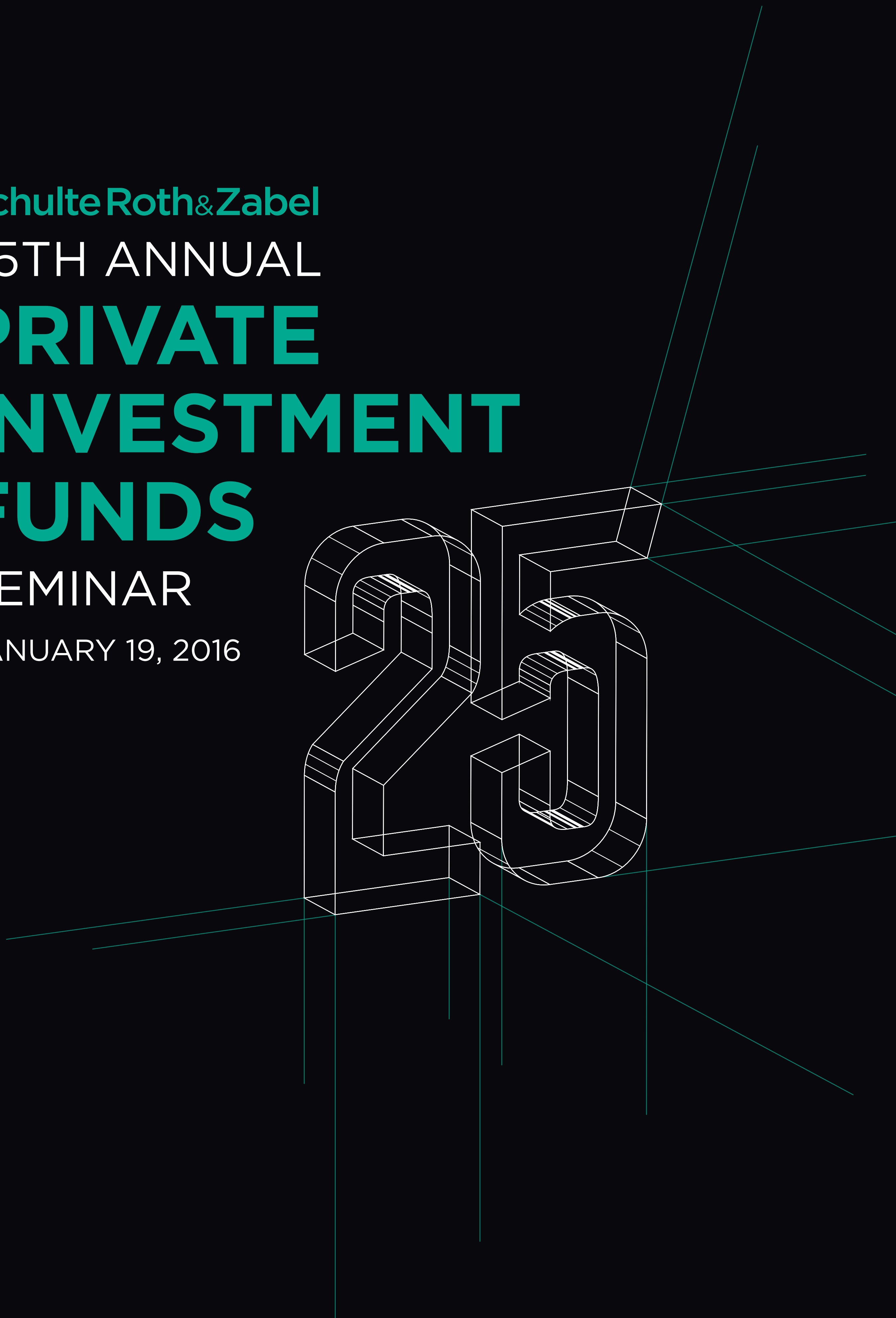

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PRIVATE INVESTMENT FUNDS SEMINAR

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Data Protection and Collection: Cybersecurity, Insurance and Data Scraping

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Jason's practice concentrates on corporate and securities matters for investment managers and alternative investment funds. He represents institutional and entrepreneurial investment managers, financial services firms and private investment funds in all aspects of their business. He advises managers of hedge, private equity and hybrid funds regarding the structure of their businesses and on day-to-day operational, securities, corporate and compliance issues; structures and negotiates seed and strategic investments and relationships and joint ventures; and advises investment managers with respect to regulatory and compliance issues.

Jason has been recognized by both *IFLR1000* and *New York Super Lawyers* as a "Rising Star," and he publishes and speaks often about topics of concern to private investment funds. He is the co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and of "Information Security: Obligations and Expectations," a Schulte Roth & Zabel white paper. In his recent speaking engagements, he has discussed co-investments, considerations for managers in their first five years of operations, and marketing opportunities and challenges for funds.

Jason earned his J.D. from Fordham University School of Law and his B.S. from the University of Michigan.

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Ted practices in the areas of insurance law, environmental law and litigation, counseling investment funds and other corporate clients with regard to a wide range of issues and disputes. In addition to environmental and insurance coverage litigation in state and federal court as well as in the context of alternative dispute resolution, Ted's practice includes counseling of clients concerning various specialty insurance policies, including directors' and officers' liability, professional liability and specialty pollution products. He regularly represents investment funds in connection with the negotiation of management liability insurance policies, including working closely with insurance brokers to negotiate favorable policy terms and providing assistance in the event that insurance claims arise. Ted's environmental practice also includes environmental insurance coverage cases, cost recovery actions, regulatory matters and parkland alienation disputes.

Ted has been a co-author of the *New York Law Journal*'s Corporate Insurance Law Column since 2003, and in 2014, he received the Burton Award for Distinguished Legal Writing. His most recent columns include "Insurance Implications of New Justice Department Policy Directive," "Cyber-Risk Insurance Update" and "Return to the Bear Stearns' D&O Insurance Dispute." At recent seminars and events, he has addressed insurance topics of concern to investment funds, including issues related to regulatory risks and examinations, cybersecurity, policy negotiation and understanding key policy terms.

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Rob chairs Schulte Roth & Zabel's Intellectual Property, Sourcing & Technology Group and is a member of the Finance and Vendor Finance groups. He also co-heads the Cybersecurity Group, which works with alternative asset managers, financial institutions and companies operating across a broad range of industries in managing the risks associated with data protection and privacy laws. Rob focuses his practice on the preparation and negotiation of various types of commercial agreements, including agreements for information technology transactions (outsourcing, software, data and content licensing, hardware supply and strategic alliances), specializing in vendor agreements for investment managers. He also works on agreements for equipment finance and leasing transactions, with an emphasis on vendor finance programs (private label programs, virtual and actual joint ventures and referral programs), and supply agreements for components and finished goods, as well as "take-or-pay" agreements, joint engineering, research & development relationships and technology-sharing arrangements. Rob also handles a broad range of services agreements, including transition and long-term services in merger and acquisition transactions.

Selected by *New York Super Lawyers* as a top business/corporate lawyer, Rob has been a member of the executive committee of the New York State Bar Association's Intellectual Property Section and is a former chair of that section's Committee on the Proposed Uniform Computer Information Transactions Act. He is the author of "Model Cybersecurity Contract Terms and Guidance for Investment Managers to Manage Their Third-Party Vendors" in *The Cybersecurity Law Report,* and he is co-author of "Securities, Futures Regulators Increase Scrutiny, Expectations on Cybersecurity" in *Bloomberg Brief — Financial Regulation* and of "Information Security: Obligations and Expectations," an SRZ white paper. He has addressed topics including information security for private funds, and IP and IT strategies in connection with M&A transactions at recent conferences.

Rob earned his J.D., with honors, from the George Washington University Law School and his B.A., with honors in political science, from the University of Louisville.

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Michael focuses his practice on white collar criminal defense and investigations, securities enforcement, internal investigations, accounting fraud, cyber crime and data security matters, as well as related civil litigation. He also leads internal investigation and cyber crime-related representations for financial services companies and provides guidance on drafting written information security plans and incident response plans for investment advisers. He spent six years serving in the U.S. Attorney's Office for the Eastern District of New York, where he investigated and prosecuted cases in the Criminal Division and the Business and Securities Fraud Section involving securities fraud, investment adviser fraud, bank fraud, cyber crime, intellectual property crimes, tax fraud, money laundering, health care fraud, false claims act cases, Federal Food, Drug, and Cosmetic Act violations, and other regulatory offenses. He also served as the co-coordinator for Computer Hacking and Intellectual Property crimes. Michael clerked for the Honorable Samuel A. Alito, Jr. of the U.S. Court of Appeals for the Third Circuit (now a Justice of the U.S. Supreme Court), and the Honorable Milton Pollack of the U.S. District Court for the Southern District of New York.

The Legal 500 United States has recognized Michael as a leading lawyer in his field. A frequent speaker and writer, he most recently co-authored "Securities, Futures Regulators Increase Scrutiny, Expectations on Cybersecurity" in *Bloomberg Brief – Financial Regulation*, "New SEC Cybersecurity Guidance: What It Means for Fund Managers" in *The Hedge Fund Journal* and "Information Security: Obligations and Expectations," a Schulte Roth & Zabel white paper. His speaking topics cover issues including cybersecurity and data protection, the convergence of information and physical security of health care information, cyber readiness for financial institutions and managing information security and IT business architecture for hedge funds. He also presents "Treatises and Complex Litigation" as the annual guest lecturer at a Yale Law School research class.

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Data Protection and Collection: Cybersecurity, Insurance and Data Scraping

I. Cybersecurity

Information security is not only a good idea — it's a legal obligation. Federal and state laws impose obligations on businesses, including investment advisers, to keep their data secure. Most of these laws focus on requiring businesses to take reasonable security measures. While it may take regulators and courts years to clearly define what exactly those measures are, best practices that facilitate compliance can and should be developed and followed now. This outline presents information security issues that private fund managers need to address, from complying with the SEC's and the CFTC's cybersecurity guidance, to handling human resources and insurance concerns.

A. Introduction

1. "Reasonable" Cybersecurity

There are federal and state laws that impose obligations on businesses, including investment advisers, to keep their data secure. Most of these laws can be summarized as follows: Take reasonable security measures.

2. Existing Rules

(a) Investment advisers must maintain data security not only because of contractual obligations (e.g., under contracts between the firm and investors or commercial vendors), fiduciary obligations, or for practical business reasons (e.g., to protect trade secrets), but also because of compliance reasons — namely, the existence of federal and state statutes and regulations that require data security. There are two major types of data security obligations:

(i) The Duty to Protect: provide reasonable security for data, systems and communications

(ii) The Duty to Disclose: disclose breaches to affected parties and regulators, and disclose material risks

(b) Right now, the applicable laws are mostly concerned with protecting the personally identifiable information of human beings (e.g., social security numbers or home addresses) ("PII").

(c) At present, 47 states (and Washington, D.C.; Puerto Rico; Guam; and the Virgin Islands) have laws concerning protection of individuals' PII. These include all states other than Alabama, New Mexico and South Dakota. (The National Conference of State Legislatures provides a list of the relevant laws.)[1]

3. Sector-Specific Laws: The Gramm-Leach-Bliley Act[2]

[1] *See* www.ncsl.org/research/telecommunications-and-information-technology/security-breach-notification-laws.aspx.

[2] Gramm-Leach-Bliley Act, 15 U.S.C. § 6801 (2006).

(a) The two most significant existing federal regulations for investment advisers and investment companies focus on protecting customers' PII.

(i) Section 30 of Regulation S-P[3]: Requires brokers, dealers, investment companies and registered investment advisers to adopt written policies and procedures designed to protect "customer records and information."[4] The protections are expected to be "administrative, technical, and physical."

(ii) Regulation S-ID, the Identity Theft Red Flags Rules: Require covered entities to develop and implement a written program to "detect, prevent, and mitigate identity theft in connection with the opening of a covered account or any existing covered account."[5]

(b) The Securities and Exchange Commission (the "SEC") has brought enforcement cases against firms for violating Regulation S-P by failing to follow or enforce cybersecurity policies and procedures.[6]

(c) Regulations S-P and S-ID are also enforced against broker-dealers by the Financial Industry Regulatory Authority ("FINRA") in accordance with FINRA's supervision rules requiring that member firms comply with applicable securities laws and rules.[7] Entities not regulated by FINRA should look to FINRA's enforcement cases to understand how regulators may approach these issues.[8]

(d) SEC staff expect registered investment advisers to adopt and maintain written information security policies (each a "WISP").

4. Sector-Specific Laws: The Investment Advisers Act

Poor cybersecurity could potentially create liability under anti-fraud and fiduciary rules of both the Investment Company Act and the Investment Advisers Act, especially given that negligence, and not intentional wrongdoing, may be sufficient to ground liability under the acts.[9]

B. Risk Alerts, Guidance and Enforcement: The Regulators' Sustained Interest in Cybersecurity

1. The 2014 Sweep

(a) In April 2014, the SEC's Office of Compliance Inspections and Examinations ("OCIE") issued a Risk Alert announcing that it would be "conducting examinations of more than 50 registered broker-dealers and registered investment advisers, and that the exams would focus on areas

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3 Securities and Exchange Commission, Final Rule: Privacy of Consumer Financial Information (Regulation S-P), 17 C.F.R. Part 248, Subpart A.

4 17 C.F.R. § 248.30.

5 17 C.F.R. § 248.201(d)(1).

6 *See, e.g.*, Exchange Act Release No. 58515, Admin. Proc. File No. 3-13181 (Sept. 11, 2008), *available at* www.sec.gov/litigation/admin/2008/34-58515.pdf; Exchange Act Release No. 64220, Admin. Proc. File No. 3-14328 (April 7, 2011), *available at* www.sec.gov/litigation/admin/2011/34-64220.pdf; Exchange Act Release No. 60733, Admin. Proc. File No. 3-13631 (Sept. 29, 2009), *available at* www.sec.gov/litigation/admin/2009/34-60733.pdf.

7 *See* NASD Rules 3010 and 3012, and FINRA has also brought enforcement cases.

8 *See, e.g.*, FINRA Letter of Acceptance, Waiver and Consent No. 2009019893801 (Nov. 21, 2011); FINRA Letter of Acceptance, Waiver and Consent No. 2010022554701 (April 9, 2012); FINRA Letter of Acceptance, Waiver and Consent No. 2008015299801 (April 9, 2010). All of these letters of acceptance are available at http://disciplinaryactions.finra.org/.

9 *See SEC v. Capital Gains Research Bureau*, 375 U.S. 180 (1963) (holding that a violation of § 206(2) may rest on a finding of simple negligence); *SEC v. Steadman*, 967 F.2d 636, 637 (D.C. Cir. 1992) (noting that a violation of § 206(4) does not require that the defendant acted with scienter).

related to cybersecurity."[10] To help registrants and their compliance professionals prepare for these examinations, OCIE included an appendix to the Risk Alert containing a seven-page "sample" cybersecurity document request. The questions suggest that OCIE is building upon existing regulations that concern risks to customers' PII and will now also assess firms' vulnerability to cybersecurity risks in general, including "misappropriation of funds, securities, sensitive … Firm information, or damage to the Firm's network or data."

(b) In other words, the data at issue was no longer just PII. It could be, for example, trading strategies or algorithms. The SEC is interested in all the risks that misuse of technology may pose to a firm's assets, including the firm's reputation.

2. 2015 Exams

(a) In January 2015, OCIE announced that cybersecurity compliance and controls would be a focus of its exams in 2015. On Sept. 15, 2015, OCIE issued a Risk Alert providing additional information on its focus. Most important, like the April 2014 Alert, the September 2015 Risk Alert included a "sample list of information that [OCIE] may review" in examinations on cybersecurity matters.[11]

(b) Topics addressed in the alert include:

(i) Governance and risk assessment;

(ii) Access rights and controls (including remote access);

(iii) Data loss prevention;

(iv) Vendor management;

(v) Training; and

(vi) Incident response.

3. IM Division Guidance

(a) The IM Division's April 2015 Guidance Update did not contain many surprises given what OCIE had already announced, but it provided additional detail on what reasonable security measures are by identifying specific techniques to consider in preventing, detecting and responding to cybersecurity threats.[12] (These are described below in the section on "Becoming Compliant: Where to Start").

(b) The Guidance Update also confirmed that mishandling cyber risks can result in violations of the securities laws by investment companies and investment advisers. That is, the document expressly contemplates that liability may result from a failure to "tak[e] appropriate precautions concerning information security."[13] In framing this discussion, the Division states

[10] Securities and Exchange Commission, Office of Compliance Inspections and Examinations, Risk Alert: OCIE Cybersecurity Initiative (April 15, 2014) ("Risk Alert"), *available at* www.sec.gov/ocie/announcement/Cybersecurity-Risk-Alert--Appendix---4.15.14.pdf.

[11] Securities and Exchange Commission, OCIE, "OCIE's 2015 Cybersecurity Examination Initiative," Vol. 1V, Issue 8 (Sept. 15, 2015).

[12] Securities and Exchange Commission, Division of Investment Management, IM Guidance Update (April 215), No. 2015-02, "Cybersecurity Guidance" ("Guidance Update").

[13] Guidance Update at 5 n.9.

that "fraudulent activity could result from cyber or data breaches from insiders, such as fund or advisory personnel, and funds and advisers may therefore wish to consider taking appropriate precautions concerning information security," citing as support anti-fraud and fiduciary rules under both the Investment Company Act and the Investment Advisers Act.[14] The Division's statement is especially striking given that some courts have held that negligence is sufficient to ground some claims under these statutes.[15]

4. Enforcement Action: *R.T. Jones*

   (a) R.T. Jones, a St. Louis-based investment adviser, consented on Sept. 22, 2015 to entry of a cease-and-desist order relating to poor cybersecurity and a breach of PII. Notably, the breach occurred before OCIE's 2014 cyber sweep, and Marshall S. Sprung, co-chief of the SEC Enforcement Division's Asset Management Unit, acknowledged that there was "no apparent financial harm to clients."[16] Nevertheless, the SEC pursued the enforcement action and fined R.T. Jones $75,000.

   (b) The order states that "from at least September 2009 through July 2013, R.T. Jones stored sensitive [PII] of clients and others on its third party-hosted web server."[17] The server was attacked in July 2013 by "an unauthorized, unknown intruder, who gained access and copy rights to the data on the server," and as a result "the PII of more than 100,000 individuals, including thousands of R.T. Jones's clients, was rendered vulnerable to theft."[18] "Shortly after the breach incident, R.T. Jones provided notice of the breach to all of the individuals whose PII may have been compromised and offered them free identity monitoring through a third-party provider."[19]

   (c) The order further stated that "the firm failed to adopt any written policies and procedures reasonably designed to safeguard its clients' PII as required by the Safeguards Rule [Regulation S-P]."[20]

   (d) Specifically, the order stated that R.T. Jones's policies and procedures for protecting its clients' information did not include "conducting periodic risk assessments, employing a firewall to protect the web server containing client PII, encrypting client PII stored on that server, or establishing procedures for responding to a cybersecurity incident."[21]

5. The CFTC

   (a) Commodity Futures Trading Commission ("CFTC") Chairman Timothy Massad noted in recent keynote speeches that cybersecurity has become "perhaps the single most important new risk

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[14] *Id.*

[15] *See SEC v. Capital Gains Research Bureau*, 375 U.S. 180 (1963) (holding that a violation of § 206(2) may rest on a finding of simple negligence); *SEC v. Steadman*, 967 F.2d 636, 637 (D.C. Cir. 1992) (noting that a violation of § 206(4) does not require that the defendant acted with scienter).

[16] Press Release, Securities and Exchange Commission, SEC Charges Investment Adviser with Failing to Adopt Proper Cybersecurity Policies and Procedures Prior to Breach (Sept. 22, 2015), *available at* www.sec.gov/news/pressrelease/2015-202.html.

[17] *In the Matter of R.T. Jones Capital Equities Management, Inc.*, Investment Advisers Act of 1940 Release No. 4204, Admin. Proc. File No. 3-16827 (SEC Sept. 22, 2015) at 2, *available at* www.sec.gov/litigation/admin/2015/ia-4204.pdf.

[18] *Id.*

[19] *Id.* at 3.

[20] *Id.*

[21] *Id.*

to market integrity and financial stability"[22] and that the CFTC was working on a rule proposal related to cybersecurity.[23]

(b) On Aug. 28, 2015, the National Futures Association ("NFA"), the self-regulatory organization for the futures industry, submitted to the CFTC a proposed interpretive notice (the "NFA's Proposal") that would apply to NFA Compliance Rules 2-9, 2-36 and 2-49, which generally require firms to diligently supervise their employees and agents or their businesses.[24] The NFA's Proposal provides cybersecurity guidance and focuses on areas similar to those in OCIE's Risk Alert.

(c) A few weeks later the CFC approved the interpretive notice, which will become effective March 1, 2016. It will apply to futures commissions merchants, commodity trading advisors, commodity pool operators, introducing brokers, retail foreign exchange dealers, swap dealers and major swap participants ("Members").

(d) The interpretive notice sets forth the general requirements that Members should implement for their information systems security programs ("ISSPs"), which include cybersecurity guidance and ongoing testing and training obligations. Requirements include the following:

  (i) Members are required to implement a written ISSP program (akin to a WISP), and in doing so are encouraged to consider standards such as ISACA's Control Objectives for Information and Related Technology ("COBIT"), and the National Institute of Standards and Technology's Framework for Improving Critical Infrastructure Cybersecurity (discussed below).

  (ii) Members are required to develop an Incident Response Plan to "provide a framework to manage detected security events or incidents, analyze their potential impact and take appropriate measures to contain and mitigate their threat."

  (iii) Each Member is also required to provide training for its employees on information security that is tailored to the risks the Member faces.

(e) CFTC commissioner Sharon Bowen suggested that bigger changes may lie ahead when she described "ideas that I think are worth considering if and when we propose a rule on improving system safeguards." These ideas included: (1) requiring each registrant to designate a chief information security officer; (2) requiring registrants to file annual or quarterly reports on the state of their cybersecurity program; (3) requiring that registrants report any material cybersecurity event to the CFTC promptly (with an example of reports being made "within minutes of a significant breach"); and (4) requiring an independent audit or annual penetration testing for all registrants.[25] While some of these proposals are consistent with current best practices, the reporting of any material event "within minutes" would be a new requirement for fund managers.

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[22] Timothy Massad, Chairman, CFTC, Keynote Address Before the Futures Industry Association Boca Conference (March 11, 2015).

[23] Timothy Massad, Chairman, CFTC, Keynote Address Before the Beer Institute Annual Meeting (Sept. 9, 2015).

[24] NFA, National Futures Association: Information Systems Security Programs — Proposed Adoption of the Interpretive Notice to NFA Compliance Rules 2-9, 2-36 and 2-49: Information Systems Security Programs (Aug. 28, 2015) (the "NFA's Proposal").

[25] Sharon Y. Bowen, Commissioner, CFTC, Keynote Address Before ISDA North America Conference (Sept. 17, 2015).

C. The NIST Framework: Why It Matters and What It Is

1. Why the NIST Framework Matters

(a) The SEC's sample questions in the April 2014 and September 2015 Risk Alerts and the NFA's interpretive guidance give hints about what "reasonable security measures" might be by steering firms toward the adoption of a published standard such as the one published by the National Institute of Standards and Technology ("NIST"), discussed below.

(b) Both the April 2014 and September 2015 Risk Alerts expressly state that some of the questions track information outlined in the "Framework for Improving Critical Infrastructure Cybersecurity," released on Feb. 12, 2014 by NIST.[26]

(c) Moreover, one question in the April 2014 appendix specifically asks the registrant to "identify any published cybersecurity risk management process standards that the entity has used to model its information security architecture and processes [on], such as those issued by NIST or the International Organization for Standardization (ISO)."

(d) NIST is a part of the U.S. Commerce Department, and the Framework is the product of a collaboration between the government and the private sector. The Framework is designed to "provid[e] a consensus description of what's needed for a comprehensive cybersecurity program."[27] It compiles, and makes reference to, similar past frameworks that other organizations have developed, such as COBIT and ISO 27001.

(e) Further, the SEC has pointed to the Framework in places other than the Risk Alerts. In a June 2014 speech, one of the SEC Commissioners, Luis Aguilar, suggested that the Framework may be a baseline for best practices by companies, including in assessing legal or regulatory exposure to cyber risks. "At a minimum," he stated, "boards should work with management to assess their corporate policies to ensure how they match-up to the Framework's guidelines — and whether more may be needed."[28]

(f) A firm is not required to use the Framework to develop its security plan, but the Framework has been highlighted by the SEC and thus it is not lightly ignored.

2. The Nature of the Framework

(a) The Framework is a deliberately general document that describes a process to apply to risks. It does not prescribe particular tools or products, such as firewalls or encryption. The generality of the document is a little frustrating, but probably essential. It is designed to be flexible enough to accommodate technology and business change.

(b) The Framework consists of three parts: the Framework Core, the Framework Profile and the Framework Implementation Tiers.

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[26] National Institute of Standards and Technology, Framework for Improving Critical Infrastructure Cybersecurity (Feb. 12, 2014) ("the Framework"), *available at* www.nist.gov/cyberframework/upload/cybersecurity-framework-021214-final.pdf.

[27] Statement by Under Secretary of Commerce for Standards and Technology and NIST Director Patrick Gallagher, *cited in* Press Release, NIST Releases Cybersecurity Framework Version 1.0 (Feb. 12, 2014), *available at* www.nist.gov/itl/csd/launch-cybersecurity-framework-021214.cfm.

[28] Luis Aguilar, SEC Commissioner, Boards of Directors, Corporate Governance and Cyber Risks: Sharpening the Focus, Cyber Risks and the Boardroom Conference, New York Stock Exchange (June 10, 2014), *available at* www.sec.gov/News/Speech/Detail/Speech/1370542057946.

(i) “The Framework Core is a set of cybersecurity activities, outcomes, and informative references that are common across critical infrastructure sectors.”[29] These activities are organized into five functions — Identify, Protect, Detect, Respond and Recover. “When considered together, these Functions provide a high-level, strategic view of the lifecycle of an organization’s management of cybersecurity risk”[30] and allow an organization to learn from past security incidents.

(ii) “The Profile can be characterized as the alignment of standards, guidelines, and practices to the Framework Core in a particular implementation scenario. Profiles can be used to identify opportunities for improving cybersecurity posture by comparing a ‘Current’ Profile (the ‘as is’ state) with a ‘Target’ Profile (the ‘to be’ state). … Profiles can be used to conduct self-assessments and communicate within an organization or between organizations.”[31]

For example, a Profile can aid communication with vendors and other third parties who have authorized access to a firm’s systems or information. A firm with a Profile has something to show its vendor, making it easier to describe what needs to be protected, and what a vendor must do before it will be granted access. Similarly, a firm could request that the prospective vendor submit its own Profile.

(iii) The Framework Implementation Tiers range from Partial (Tier 1) to Adaptive (Tier 4). They describe: (1) “an increasing degree of rigor and sophistication in cybersecurity risk management practices”; (2) the extent to which cybersecurity risk management is informed by business needs”; and (3) the extent to which cybersecurity risk management is “integrated into an organization’s overall risk management practices.”[32] In determining what Tier they desire, firms should determine which level meets the firm’s goals and “is feasible to implement.”[33]

D. Becoming Compliant: Where to Start

1. Firm-Level Risk Assessments

(a) OCIE expects that firms will maintain a detailed inventory and understanding of their cyber infrastructure. This includes physical devices, the software platforms and applications used on the network, network resources, connections and “data flows (including locations where customer data is housed).”[34]

(b) The SEC is concerned with firms’ vulnerability to cybersecurity risks in general, including “misappropriation of funds, securities, … [and] Firm information[.]”[35] Managers should accordingly review existing related policies, such as controls on processing redemption requests and IT safeguards, in a cybersecurity context.

[29] The Framework, at 1.

[30] *Id.* at 4.

[31] *Id.* at 5.

[32] *Id.* at 9.

[33] *Id.*

[34] Risk Alert, Question 24, at 6.

[35] *Id.* at 7.

(c) Every fund manager should be prepared to explain how it designed and maintains its infrastructure, its incident response plan and its training for employees. Third-party security firms can assist in this effort.

(d) Consider doing a gap analysis. Discover where the gaps in the firm's security are and close them.

(i) A gap analysis is an analysis of what you have done, where you are now, and where you want to go.

(1) "What you have done" includes any previous security reviews or audits.

(2) "Where you are now" includes any existing personnel, policies, procedures and controls you currently have in place. A full risk assessment identifying all systems, all "treasure" (what you want to protect), all risks and all residual risks after the controls are applied.

(3) "Where you want to go" means identifying any regulatory compliance needs, selecting an appropriate framework (e.g., NIST, ISO 27001) and developing a roadmap for hiring, policy development, control implementation, ongoing risk assessment, etc.

(4) The gap analysis should be done at the firm level, but also at lower levels within the firm. At the firm level, guidance is provided to the entire firm and is applicable to all types of information systems and mission objectives, and a standard risk threshold exists. Different groups at a fund manager will likely present different types of information security risks (e.g., investor relations and trading).

2. Cybersecurity Personnel

Many of OCIE's questions in its Risk Alerts focus as much on the "who" as the "what." Firms should have well-defined roles and responsibilities for cybersecurity personnel, and to that end should designate a chief information security officer, or the functional equivalent — an employee in charge of information security as distinct from IT operations. Compliance personnel should be familiar with the division of labor in the technology department.

3. Records of Cybersecurity Incidents

(a) Firms should maintain appropriately detailed records relating to cybersecurity incidents. This is one of the more significant parts of the April 2014 Risk Alert. Financial firms of course have long-standing obligations to maintain accurate books and records, but such record-keeping is not traditionally associated with cybersecurity or even technology support departments. To be sure, OCIE is not asking firms to catalogue tech support tickets; it is, however, seeking granular detail on particular security incidents, both retrospectively and going forward. For example, Question 24 of the April 2014 Risk Alert asks for details on many kinds of cybersecurity events, such as the detection of malware on a firm's devices, or the impairment of a "critical Firm web or network resource [due to] a software or hardware malfunction." This may require a considerable expansion of current record-keeping, and collaboration between cybersecurity and legal compliance personnel. The April 2014 Risk Alert does not expressly address what makes a particular incident material, but Question 24 hints that the SEC will recognize materiality concerns in some way because it allows respondents to omit some incidents that: (1) resulted in losses of $5,000 or less; (2) did not result in "unauthorized access to customer information"; or (3) did not make a firm service unavailable for "more than 10 minutes."[36]

(b) In designing their record-keeping system, cybersecurity personnel might also consider additional uses for the records beyond complying with OCIE's document requests. The records created in response to OCIE's request could also become a valuable tool for firms to use in their own internal investigations, or to assist firms if they become the victims of tortious or criminal conduct. For example, the malware used to misappropriate data can sit on a server for months before it is detected, and thus the investigation of a breach may be aided by examining seemingly unconnected events several months or even years prior. Valuable investigative resources such as log records (e.g., web server access logs and secure shell server logs) can be overwritten or deleted, so preserving the kind of information requested by OCIE in a readily accessible form may prove useful.

4. Disaster Recovery

Managers should review their existing disaster recovery plans to ensure that they are up-to-date with firm operations and that they take into account cybersecurity and identity theft prevention policies. Note that Regulation S-P requires a written business continuity plan. A good back-up policy is an essential part of protection against cryptographic extortion malware attacks ("ransomware" attacks) in which the attacker encrypts all of a firm's data and blackmails the firm in exchange for the decryption key.

5. Specific Techniques and Technologies Mentioned by the SEC

(a) As noted above, the IM Division's Guidance Update lists specific techniques that firms should consider in their efforts to "prevent, detect, and respond to cybersecurity threats." These include:

(i) Controlling access to various systems and data via management of user credentials, authentication and authorization methods;

(ii) Data encryption;

(iii) Firewalls;

(iv) Restricting the use of removable storage media (e.g., USB drives);

(v) Deploying software that monitors technology systems for unauthorized intrusions;

(vi) Network segregation; and

(vii) System hardening.

(b) The Guidance Update defines system hardening to mean "removing all non-essential software programs and services, unnecessary usernames and logins," and "ensuring that software is updated continuously."

[36] *Id.* at 6 ("If the response to any one item includes more than 10 incidents, the respondent may note the number of incidents and describe incidents that resulted in losses of more than $5,000, the unauthorized access to customer information, or the unavailability of a Firm service for more than 10 minutes.").

E. Practical Cybersecurity: Human Resources Policies and Insider and Third-Party Risk

1. Human Resources

(a) Almost every aspect of a firm's existence intersects with computers and digital data. Accordingly, cybersecurity is less a separate concern than a theme that should run through all of a firm's risk management policies. Personnel policies are no exception.

(i) Since the advent of the cellphone, employees have had firm information in the palms of their hands. As cellphones have become smartphones, the amount of firm information that employees have access to at all times has increased exponentially. As Bring-Your-Own-Device ("BYOD") practices have spread, the wall between personal and business use has grown thinner. Now, many employees own the devices on which they work, and they engage in both business and personal activities on the same device.

(ii) Technological change — in particular the BYOD trend — heightens employee security risks:

(1) Lost or Stolen Devices: Mobile devices are more likely than desktop computers to be lost or stolen.

(2) Cloud-Based Storage: Firm data saved in "cloud" storage by employees may be unsecure and out of the firm's reach.

(3) Wireless (In)security: Data traveling on unsecured wireless networks can easily be stolen.

(4) Downloads/Uploads: Malware may cause damage to a firm's system and threaten its security.

(5) Friends and Family: Mobile devices may be accessed by friends or family.

(b) Disgruntled/Disloyal/Terminated Employees

(i) Firm-owned devices, and the business data stored thereon, can readily be secured, studied, and wiped by the firm. Most court decisions involving employee challenges to an employer's access to personal data based on privacy concerns have favored the employer and have turned on the fact that the employer owned the device or system on which the information was stored or transmitted. By contrast, a device owned by an employee that contains personal data may not be readily secured legally. Relevant federal statutes include the Electronic Communications Privacy Act ("ECPA") and the Computer Fraud and Abuse Act ("CFAA").

(1) ECPA: Title I prohibits wiretapping by private entities unless: there is consent from one party; it is for a legitimate business reason; it is routinely conducted; and, in some federal appellate court circuits, the parties to the communication are informed that they are being monitored. There are exemptions for publicly accessible radio communications, government officials and communication services providers. Title II (the Stored Communications Act ("SCA")) bans surreptitious access to stored communications like email, social media messages and text messages. The SCA makes it a crime to intentionally access without authorization or exceed an authorization to access stored communications. Therefore, employers may not

access an employee's web-based personal email; nor can they access password-protected social media posts without consent.[37] Some courts have held, however, that if the communications pass through firm servers or are stored on firm equipment (e.g., hard drives), employers may access personal email and social media posts.[38]

(2) CFAA: The CFAA prohibits employers from intentionally accessing a computer without authorization. Employees have sued their employers under the CFAA for accessing the employees' phones, devices or accounts without authorization.[39]

(3) Twenty-four states (Arkansas, California, Colorado, Connecticut, Delaware, Illinois, Louisiana, Maine, Maryland, Michigan, Missouri, Montana, Nevada, New Hampshire, New Jersey, New Mexico, Oklahoma, Oregon, Rhode Island, Tennessee, Utah, Virginia, Washington and Wisconsin) have passed so-called "anti-snooping" laws prohibiting employers from demanding passwords to access personal email and social networking sites. There is no federal equivalent yet. New York has several bills pending on the same subject.

(ii) To avoid running afoul of these statutory protections, and to protect firm information, firms should:

(1) Obtain advance authorization to access and wipe the firm's information stored on employee-owned mobile devices;

(2) Consider using mobile management software to, among other things, create a "corporate sandbox" that segregates firm information from personal information (and consider that even though it may be technologically possible to access personal information on a dual-use device, there is a downside to doing so);

(3) Clearly delineate where work cannot be done (e.g., prohibit firm work on personal email accounts); and

(4) Craft policies and procedures that ensure that employees do not have an expectation of privacy with respect to firm information on their own devices or personal information transmitted using the firm's technology or stored on the firm's systems.

(iii) Proprietary and Trade Secret Information

(1) A critical element of proof in a trade secret theft case is that the employer has taken "reasonable measures to protect" the information it claims was misappropriated.[40] The evidentiary burden is difficult to meet when the information walks out the door every day in employees' pockets.

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[37] *See, e.g.*, *Pure Power Boot Camp v. Warrior Fitness Boot Camp*, 587 F. Supp. 2d 548 (S.D.N.Y. 2008).

[38] *See, e.g.*, *Front, Inc. v. Khalil*, 2013 N.Y. Misc. LEXIS 3157 (N.Y. Co. 2013).

[39] *See, e.g.*, *Rajaee v. Design Tech Homes, Ltd.,* 2014 U.S. Dist. LEXIS 159180 (S.D. Tex. 2014).

[40] *See MidAmerica Prods., Inc. v. Derke*, 2013 N.Y. Misc. LEXIS 1211 (N.Y. Co. 2013) (holding that customer information sheets were not a trade secret because "plaintiffs did not take any reasonable measures to guard the secrecy" when anyone in the office with access to the computer had access to the data).

(2) Employees can misappropriate firm information in a variety of ways. For example, they may photograph documents or screens or surreptitiously record discussions, and because smartphones are ubiquitous, the theft may not be obvious. Or employees may electronically transfer data, using email, Internet-based storage or portable storage drives.

(3) To protect firm information, in addition to using traditional measures such as confidentiality agreements and policies, firms should take technical precautions, including restricting access to trade secret data (e.g., by using proprietary software source code for trading algorithms), disabling transmission of information to portable drives, encrypting information and compartmentalizing information (so that no single individual can misappropriate a particular trade secret).

(iv) Employee Speech Protections

(1) Recently the National Labor Relations Board ("NLRB") has been pursuing employers, both unionized and not unionized, challenging overly broad policies that chill employee speech and terminations stemming from employee speech on social media sites.

(2) Section 7 of the National Labor Relations Act of 1935 ("NLRA") gives employees the "right to self-organize, to form, join, or assist labor organizations … and to engage in other concerted activities … ." Concerted activity includes speech regarding discontent with an employee's current employer, including complaints about wages or a tough boss.

(3) The NLRB has concluded that a policy banning personal use of business devices chills concerted activity and, therefore, is too broad. The NLRB has also concluded that policies that prohibit employees from saying anything about their employers on social media sites are overly broad.[41] To comply with the NLRA, policies should permit non-excessive personal use of the firm's systems and limit prohibitions with respect to social media.[42] Policies should, however, prohibit employees from using systems that an employer cannot access (such as personal web-based emails) for business.

(v) Training

Training employees is critical because many security incidents are the result of employee error or misconduct. The consequences of comingling personal and business data and functions on one device are not intuitive to employees. Many problems are not caused by disgruntled employees acting intentionally. Rather, they are caused by innocent insiders. Training will go a long way toward mitigating the risk.

(vi) Elements of a BYOD Policy

(1) Restrictions: A comprehensive BYOD policy should include provisions regarding password protection, encryption of firm data that is stored on the device, lock or

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[41] *See Durham School Servs., L.P.*, 360 N.L.R.B. 85 (2014) (a prohibition on sharing information "related to the company or any of its employees or customers" was overbroad and too vague under the NLRA).

[42] *Landry's Inc.*, No. 32-CA-118213 (N.L.R.B. A.L.J. June 26, 2014) (a policy that urged employees not to post about the company was found not to violate the NLRA because it was not an outright prohibition).

wipe after a certain number of unsuccessful access attempts, restrictions on the source of apps (e.g., only Apple or Google), no friends or family access and no storage of corporate data on remote servers through consumer-grade "cloud" storage services. If a firm chooses to use cloud storage, it should carefully select an enterprise-grade provider that provides better encryption and the ability to monitor and wipe what an employee has stored. Employers should also require immediate reporting of lost or stolen devices, use of mobile management software with remote wiping capabilities and use of passwords with safeguards to prevent hacking and misuse of information on the device.

(2) Monitoring: In addition, employers should alert employees that they have no privacy expectation in firm data on the phone or personal data transmitted using the firm's software installed on the phone (e.g., firm email); firms should get consent to monitor data that is stored, sent from or received on the device; and firms should get consent to remotely wipe firm information if the device is lost or stolen and upon termination of employment.

(3) Coordination with Other HR Policies: Employers should ensure that BYOD policies do not conflict with other HR policies and specify that any other policies such as EEO, anti-harassment, confidentiality and compliance policies apply to work done on the device.

(4) Provisions Contemplating Termination of Employment: Security issues are most acute upon termination of employment. Remote-wiping capabilities are especially important in this circumstance. Employers should obtain prior permission to wipe the phone of firm information. Using a corporate cloud service and setting up a corporate "sandbox" for employees to use helps preserve the integrity of firm information, but will not capture all firm data if some continues to be stored on the device itself. Employers should therefore require employees to consent to an inspection of the device during and upon termination of employment.

(5) Compliance with Record-Keeping Obligations: Whether or not a firm has a record-keeping obligation depends on the content of the communication rather than the platform used to communicate. If text messages include communications that relate to recommendations or advice by a registered investment adviser, they are subject to the record-keeping obligations under Rule 204-2 of the Investment Advisers Act.[43] Employers should make sure that they have access to and maintain all information that is subject to record-keeping obligations. In addition, policies should allow for retrieval of employee-owned devices for compliance-related inquiries. It is good practice to maintain separate, work-specific, employer-controlled accounts for employees to use on sites such as LinkedIn if they use those platforms for communicating with clients.

2. Third-Party Risks: Vendor Management

(a) Risks to investment advisers from third parties, and specifically vendors, are a major concern of the SEC. Such third parties include fund administrators, prime brokers, consultants and commercial vendors. Regulators are concerned about the firm's management of third-party vendors, including cybersecurity risk assessment of vendors, training materials used for

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[43] OCIE, Investment Adviser Use of Social Media, National Examination Risk Alert (Jan. 4, 2012), at 2; *see* 17 C.F.R. § 275.204-2.

vendors, segregation of sensitive data from third-party access, and security applied to control remote systems access by vendors.

(b) Vendors currently face an array of forms all seeking the same information but using different terms and formats; there is not yet a standard Due Diligence Questionnaire ("DDQ"). Some industry groups are trying to develop a standard, however. For example, the Alternative Investment Technology Executives Club ("AITEC") has designed a document. It is also possible that in the near future, SOC 2 compliance certification will be the industry standard and a lot of DDQs can be avoided with accounting firm certification.

(c) The Diligence Process: Choosing a Vendor

(i) It is prudent to investigate a proposed vendor and its creditworthiness prior to entering into a contract, especially if the vendor is not a household name.

(ii) Some vendors will not negotiate changes to their agreements. In this situation, discomfort with the vendor's contract provisions can be soothed somewhat if the investment adviser can get comfortable with the vendor's product and the vendor itself. The best source of this due-diligence information is other customers of the vendor. It is routine for vendors to offer customer references. Investment advisers should take advantage of these offers.

(iii) Ask for and review the vendor's written information security program, business continuity plan, vendor management plan and incident response plan. It is standard practice for the vendor to provide copies of the plans and agree to be contractually bound by the plans.

(iv) The vendor should advise what industry standards it follows (such as ISO or NIST).

(v) The vendor should identify any subcontractors that will have access to sensitive information and should provide diligence material for each subcontractor.

(vi) The vendor should agree to preserve information consistent with any instructions the firm provides, including any litigation and regulatory holds.

(vii) The firm should incorporate data security requirements into its vendor contracts. An SRZ-authored publication includes a fairly comprehensive set of data security-related contract provisions that an investment adviser can try to incorporate into its vendor contracts.[44] These provisions apply to firm-hosted licensed software, vendor-hosted software-as-a-service, and cloud-based vendor arrangements.

3. Practical Recommendations

No firm's data will be totally secure, but practical steps can be taken to protect a firm against data breaches:

(a) Employee Training: The most important defense against phishing attacks is to train employees not to interact with suspicious emails.

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[44] *See* Robert R. Kiesel, "Model Cybersecurity Contract Terms and Guidance for Investment Managers to Manage Their Third-Party Vendors," 1 *Cybersecurity Law Report*, No. 6 (June 17, 2015) *available* at www.srz.com/Model_Cybersecurity_Contract_Terms_and_Guidance_for_Investment_Managers_to_Manage_Their_Third-Party_Vendors/.

(b) Passwords and RSA Security Codes: Restricting system access to users that belong on the system is an obvious and reasonable requirement.

(c) Email Filters: Spam filters are a significant block to phishing attacks and malware.

(d) Limitation on Administrative Privileges: Limiting the number of employees with broad system access limits the damage an intruder can cause once the intruder successfully breaches the firm's security layers.

(e) Technological Devices: Technological devices such as email sandboxes (which allow email to be checked for malware before it can do damage) and virtual air-gapping (allowing Internet access via a vendor's system without exposing the firm's devices) are expensive and may slow down systems, but they can provide effective security.

(f) Limitation on Large Downloads: Restricting flash drive downloads by employees limits information lost through employees.

F. Data Breaches

1. Incident Response Plan

(a) The purpose of an Incident Response Plan is to define a firm's procedures for reporting and responding to security incidents that may compromise the availability, integrity and confidentiality of a firm's information systems, network resources or data.

(i) Of course, as with all plans, the point is to develop a course of action before a problem occurs. This is better than assembling one after the breach happens at 8:00 p.m. on New Year's Eve.

(ii) As ever with compliance documents, terminology varies, but one way to think of the plan is in six parts: Preparation, Identification, Containment, Mitigation, Recovery and Follow-Up.

(1) Preparation: Developing and testing procedures, and training personnel.

(2) Identification: Assigning responsibility for managing the response to an incident, determining the scope of the incident, and, if appropriate, notifying the security incident response team.

(3) Containment: Assessing the risk of continued operations and preventing further loss or damage.

(4) Mitigation: Determining the cause of a security incident and plugging the holes.

(5) Recovery: Returning all data and services impacted by a security incident to full operational status.

(6) Follow-Up: Identifying lessons that make future responses more effective.

(iii) Preparation should include maintaining and analyzing logs on information systems and network resources. All information systems and network resources should use synchronized time so that simultaneous, near-simultaneous, or contiguous events on different systems can be properly identified. Preparation should also include regular backing up of information systems, and regular restoration tests to ensure the backup media is usable.

(iv) In drawing up a plan, don't just think of the dramatic incidents. A security incident could be a breach by an outside attacker, but it also includes more prosaic events such as the loss of laptops, mobile phones or RSA keys. And failing to handle the more prosaic events is more embarrassing, and thus potentially more damaging.

(v) Assemble a team that includes various parts of the firm such as:

(1) Tech security;

(2) Tech operations;

(3) PR;

(4) Audit; and

(5) Legal.

Specify points of contact for each department and allocate responsibilities, and distribute the list in a way that it can be accessed in an emergency.

(6) Develop responses to the most likely attacks (e.g., phishing and insider threats).

(7) Test the response plan — regularly, not just when it is first developed.

(8) Update the plan regularly, and when a significant technology change event occurs — such as the switch to a new off-site data center, the implementation of a major new piece of software, etc. Also, re-evaluate the plan after each significant incident.

(9) One helpful resource is NIST's Computer Security Incident Handling Guide.[45]

2. Reporting

(a) When to report a data breach (and what to report about it) is very fact-specific. Factors that matter include the nature of the data (e.g., whether it was PII), the residence and number of individuals whose information has been compromised, and whether the data was encrypted.

(b) Timing of the Disclosure. State laws vary but typically require that affected persons be notified of PII breaches without unreasonable delay. As discussed below, most states also typically allow for delay due to cooperation with law enforcement.

(c) Form of the Disclosure. Affected persons should typically be notified by either written notice, electronic notice or, sometimes, substitute notice. Substitute notice typically consists of a combination of email notification, a message posted on the firm's website and publication in statewide media. Substitute notice is not permissible unless the breached firm lacks sufficient contact information for the affected persons, or if the firm can show that notice will cost more

[45] *See* Paul Cichonski et al., Computer Security Incident Handling Guide, Special Publication 800-61, Revision 2 (August 2012), *available at* http://nvlpubs.nist.gov/nistpubs/SpecialPublications/NIST.SP.800-61r2.pdf.

than a certain amount (different for different states) or must be provided to a certain number of people (also different for different states). For example, substitute notice is allowed by Maine and New Hampshire if the cost exceeds $5,000 or the firm must notify more than 1,000 individuals, but other states have thresholds of $250,000 or 500,000 individuals.

(d) There is oftentimes no obligation to report a security breach to the SEC or to prepare any particular document regarding the breach and how the firm addressed it. But an internal breach report, and related documentation, may be useful in demonstrating the firm's efforts to address information security concerns.

3. Attorney-Client Privilege and Incident Response

(a) Try to protect your deliberations. It will make the substance and outcome of your third-party deliberations better.

(b) Merely copying your lawyer on a communication doesn't make it privileged.

(c) But if incident response or after-action reports are conducted at the direction of a lawyer, it is more likely that courts will find them to be privileged.

4. Evidence Collection

(a) Document as much as possible — actions that are performed by IT, conversations with users and system owners regarding the incident, etc.

(i) The point is to know what happened when, and what the decision-making process was.

(1) This information may help a firm to improve its future responses.

(2) This information may also help protect the firm from second-guessing by litigants. It allows the firm to show that the ultimate solution wasn't the only possible solution, and that the interim theories were reasonable.

(b) "Preserve evidence from the incident. Make backups (preferably disk image backups, not file system backups) of affected systems. Make copies of log files that contain evidence related to the incident."[46]

(c) To the extent possible, preserve evidence in a way that doesn't alert the suspected culprit. For example, think carefully about circulating a litigation hold. Who is in the circle of trust?

5. Communicating and Working with Law Enforcement

(a) Under many state laws, a firm that is cooperating with a criminal investigation may delay its breach disclosure to affected individuals.[47]

(b) Some things to consider:

[46] *Id.*, Appendix G, at 68.

[47] *See, e.g.*, Cal. Civ. Code § 1798.82(c); Conn. Gen. Stat. Ann. § 36a-701b(d); Fla. Stat. Ann. § 817.5681(3); Mass. Gen. Laws Ann. Ch. 93H, § 4; N.Y. Gen. Bus. Law § 899-aa(4); and Tex. Bus. & Com. Code Ann. § 521.053(d).

(i) If a firm wants to pursue its own litigation, criminal litigation may take precedence. Civil litigation is often (but by no means invariably) stayed when there is a parallel criminal case.[48] So getting law enforcement involved usually means diminishing control.

(ii) On the other hand, if the firm has had to disclose a breach to affected individuals, the firm may be contacted by the Secret Service or FBI anyway. By taking affirmative steps, the firm might keep more control of the situation, or at least keep lines of communication with law enforcement open.

(iii) Law enforcement has investigatory tools that private firms do not (e.g., search warrants and contacts in international law enforcement).

(iv) When talking to investigators, a firm has to be accurate, of course. The firm may have to discuss aspects of a hack it has seen but doesn't understand.

(v) Get outside counsel involved in dealings with law enforcement.

(c) Personal relationships can matter in terms of responsiveness and communicating with law enforcement. This may also determine whether to call the FBI, Secret Service, or a particular U.S. Attorney's Office or state District Attorney's office to ask them to open an investigation.

(d) What will law enforcement want?

(i) Don't do something that tips off the attacker. That could lead to destruction of evidence, or the creation of new back doors allowing the attacker to come back later.

(ii) Law enforcement may want assistance with undercover operations.

(iii) Preserve Evidence: Don't assume that you should turn off computers — that will result in loss of volatile memory. It may be OK to disconnect from the Internet. Talk to the tech and security team, and ask law enforcement before you do it.

G. Insurance

The market for cyber risk insurance coverage is growing and more financial services entities, including investment advisers, are considering purchasing coverage to mitigate losses associated with data breaches.

1. Survey Results

(a) OCIE's Cybersecurity Examination Sweep Summary (February 2015) indicates that:

(i) 58 percent of the broker-dealers surveyed maintain insurance for cybersecurity incidents.

(ii) 21 percent of investment advisers have purchased insurance that covered losses and expenses due to cybersecurity incidents.

(b) The *HFMWeek*/JLT Specialty Survey (Fall 2015) indicates that:

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[48] *See* Milton Pollack, *Parallel Civil and Criminal Proceedings*, 129 F.R.D. 201 (S.D.N.Y. 1989); *Parker v. Dawson*, No. 06-CV-6191 JFB WDW, 2007 WL 2462677 (E.D.N.Y. Aug. 27, 2007); *S.E.C. v. Boock*, No. 09 CIV. 8261 (DLC), 2010 WL 2398918 (S.D.N.Y. June 15, 2010); *but see S.E.C. v. Saad*, 384 F. Supp. 2d 692 (S.D.N.Y. 2005) (Rakoff, J.).

(i) 15 to 20 percent of hedge funds have purchased cyber risk insurance.

(ii) Of those that have not purchased, 28 percent of hedge funds "want to learn more" about cyber insurance; 19 percent don't know what it is or never heard of it.

2. Traditional Insurance Policies

(a) Crime Policies and Fidelity Bonds

(i) Crime policies may provide coverage for theft of funds or tangible property such as losses due to computer theft, forgery or electronic fraud.

(ii) These policies do not typically provide coverage for loss due to stolen data, unauthorized disclosure of information, or system losses due to a virus or other electronic attack.

(b) General Liability Policies

(i) General liability policies typically provide coverage for damages from bodily injury or property damage caused by an occurrence. This coverage does not typically extend to data breach loss.

(ii) Some general liability policies also provide coverage for personal and advertising liability. In order for such coverage to be triggered, the loss has to arise from publication that violates a person's right to privacy. Courts rejected data breach claims under general liability policies in the *Sony* and *Recall Total Information Management* cases.[49]

(1) In *Sony*, in connection with the Sony PlayStation data breach, the New York court held that the activities of third-party hackers did not constitute "publication" by the policyholder and therefore rejected Sony's claim for coverage.

(2) In *Recall Total Information Management*, the Connecticut Supreme Court affirmed the ruling that the loss of computer tapes containing PII of employees did not trigger the general liability policies because there was no "publication" of the information stored on the tapes.

3. Cyber Risk Insurance Policies

(a) Application and Underwriting

(i) To apply for cyber risk insurance, an investment manager will need to fill out a fairly extensive application that describes, among other things, the type of confidential records maintained, network and computer systems, security controls, and internal information security policies and procedures.

(ii) This information is evaluated by the insurer's underwriting and loss control professionals. This process can provide the investment manager with valuable feedback concerning its information security profile.

(b) Coverage for Third-Party Claims

[49] *Zurich American Insurance v. Sony*, 2014 WL 3253541 (N.Y. County Feb. 24, 2014); *Recall Total Information Management, Inc. v. Federal Insurance Co.*, 317 Conn. 46 (Conn. 2015).

(i) Policies should cover claims by third parties: customers, investors, business partners and regulators.

(ii) Such claims may include, for example, claims for damages arising from unauthorized disclosure of personal and financial data, failure to detect and prevent a data breach, and destruction of critical business records. Third-party claims may also include breach of the insured's own written privacy policy or the violation of applicable privacy laws or regulations. Some policies also provide coverage for third-party claims for libel, slander, defamation, copyright infringement, invasion of privacy, or other claims based on material published on a website or social media space.

(iii) Coverage includes defense costs, which can be significant. For example, news reports of a data breach in the retail arena are often followed soon after by a purported class action lawsuit seeking damages on behalf of customers. These class action lawsuits often face significant obstacles, in particular with regard to standing and damages, but defense costs can still be significant.

(c) Coverage for First-Party Claims

(i) First-party claims include claims for costs incurred to investigate and respond to data breach incidents. Covered costs should include fees for computer experts, legal counsel and crisis management professionals.

(ii) Covered loss may include:

(1) Data restoration costs;

(2) Computer forensics to analyze the scope and cause of a data breach;

(3) Legal analysis of applicable law regarding reporting and notification;

(4) Privacy notification services (including credit monitoring); and

(5) Crisis management expenses.

(iii) Coverage may also include:

(1) Business interruption loss and extra expenses;

(2) Cyber extortion response costs; and

(3) Regulatory fines and penalties.

(d) Exclusions

(i) Cyber risk policies typically contain a lengthy list of exclusions, but many of these exclusions serve the primary purpose of avoiding overlapping coverage by excluding loss that is traditionally covered under other insurance policies including management liability, general liability, employment practices liability and environmental insurance policies.

(ii) Some of the standard exclusions are similar to the exclusions that are contained in D&O and management liability insurance policies. For example, claims arising out of fraud or intentional illegal conduct will be excluded, as will claims arising out of pre-existing known breaches.

(iii) As cyber claims experience grows, insurers will likely begin to refine exclusions or insert new exclusions unique to cyber issues. The following claims are typically excluded in some form in cyber risk policies:

(1) Claims arising from an act of war;

(2) Claims arising from electrical or mechanical failure that causes an interruption of service from a utility or internet service provider; and

(3) Claims arising from natural disasters.

Some policies may also exclude claims arising from the uploading of music, photos, videos and games.

(e) Comparing Insurance Policies and Carriers

(i) There is currently no such thing as a standard cyber risk policy. Policy forms use similar but different terms and definitions. For example, some forms use the terms "Security Failure" and "Privacy Event," while other forms use the terms "Cyber Liability" or "Network Security Liability" and "Privacy Violation Liability." Over time, we expect the forms to evolve, as management liability policies have, so that the terms are more comparable.

(ii) To compare policies in the current climate, it is important to carefully review defined terms and exclusions to evaluate the scope of coverage. For example, it is important to confirm that loss arising from unauthorized disclosure of an insured's information due to a data breach at a third-party service provider is covered. It is also important to confirm that disclosures arising from the use of mobile devices are not excluded.

(iii) As part of the first-party coverage, many insurers offer a list of preferred vendors that can provide technical, legal and crisis management services in the event of a data breach. In some policies use of the insurers' preferred vendors is mandatory while in other policies it is optional.

(iv) Recently, a few insurers have begun offering some cyber liability coverage as an optional part of their management liability insurance policies. This coverage is likely to be more narrow than what is offered in a separate cyber risk policy.

(v) Premiums for cyber risk insurance for investment managers and funds have remained relatively inexpensive due in part to the absence of noteworthy claims in this market.

II. Data Collection: Web Crawling, Data Scraping and Other Automated Data Collection Methods

A. Many investment managers use automated data collection to analyze prospective investments. Automated data collection uses technological devices called "robots" or "bots" to collect data from

Internet websites. This practice is often referred to as "data scraping,"[50] and the bots are called "web crawlers" or "web spiders."

B. Automated data collection raises legal issues for the data collector, including:

1. Breach of contract (where a website's terms of use[51] prohibit collection);

2. Copyright infringement (where information that is taken by the collector is protected by copyright);

3. Trespass to chattels (where the data collection interferes with the website operator's systems or platform); and

4. Claims under the Computer Fraud and Abuse Act ("CFAA")[52] (where the collection evades technological measures used by the website operator to disable or redirect data-collecting robots).

C. Given these potential issues, investment advisers should consider the following steps:

1. Comply with EULA terms.

Almost every website has an end-user license agreement ("EULA") that a new user is required to click through to acknowledge that the EULA's terms will apply to the user's use of the site. Failure to abide by EULA terms could give rise to a breach of contract claim. Legal issues relevant to assessing a claim include the enforceability of the EULA as a whole (e.g., was the EULA conspicuously displayed and clearly acknowledged by the owner?) and whether the applicable specific EULA terms are enforceable (i.e., are the terms that have been allegedly breached void as unconscionable, illegal or against public policy?). Factual questions include whether the specific use that the data collector is making of the data is prohibited by the language of the EULA and, if so, whether the website operator can show damages. Some EULAs have liquidated damages provisions, which some courts have enforced (when reasonable) in the absence of being able to quantify actual damages.

2. Comply with any robots exclusion protocol.

In addition to the EULA terms, many websites employ a protocol called "robots.txt" that communicates directly with web crawlers and other data collection robots. The protocol provides direction to the robot about which areas of the website may not be scanned or scraped. An investment adviser collecting data should require its bots to follow websites' protocol directions.

3. Do not seek to evade technical measures that a website operator has in place to stop automated data collection.

(a) The Digital Millennium Copyright Act of 1998 ("DMCA")[53] states: "No person shall circumvent a technological measure that effectively controls access to a work protected under this title."

[50] "Web crawling," "web spidering," "web indexing," "Internet indexing," "web scuttling," "web harvesting," "web data extraction" and "data scraping" are all terms that refer to automatic data collection from the web, wherein a robot collector will copy and store data based on the robots set of search parameters. While many of these names are treated as synonyms for each other, generally "web scraping" refers to very targeted data collection (often set to regularly collect specific information from individual websites), while "web crawling" is relatively indiscriminant collection throughout the web (often used by search engines to index hyperlinks from the surface web).

[51] End-User License Agreements or "EULAs."

[52] Computer Fraud and Abuse Act, 18 U.S.C. § 1030 (2015).

[53] Digital Millennium Copyright Act, Pub. L. No. 105-304, 112 Stat. 2860 (1998) (codified as amended in scattered sections of 5, 17, 28, and 35 U.S.C.).

The DMCA allows for both civil remedies and criminal penalties for violations under the anti-circumvention provisions. If the violations are determined to be willful and for commercial purposes or private financial gain, the court can order significant fines and/or imprisonment.

(b) Where website owners take steps to prevent automated data collection by a specific party (for example, by blocking the IP address of a bot known to perform automated data collection) and the data collector attempts to evade this restriction (for example, by hiding its IP address), this could give rise to both civil and criminal liability under the federal Computer Fraud and Abuse Act, a statute that prohibits access to a computer, website, server or database either "without authorization" or in a manner that "exceeds authorized access." While the emerging trend is to apply the CFAA only to instances of "hacking," and not to uses of information on publicly available websites that merely violate the EULA, claims may arise under the CFAA in specific instances in which permission to a specific user is revoked and the user nevertheless seeks to continue to access the website.

4. Do not overwhelm the IT systems of the website operator.

   If automated data collection can be shown to take up a measurable amount of the website operator's bandwidth (thus interfering with the website operator's use of its tangible property), this could give rise to a claim of trespass to chattels. Seriously overwhelming a website with multiple or repetitive searches could also be considered to be a denial-of-service attack that may violate the CFAA.

5. Don't compete with the business model of the website being collected from.

   Make sure that the use made of the information being taken is not a substitute for the goods or services offered by the website operator, and that the use does not reduce the revenues of the website operator.

6. Use the collected information internally if possible.

   As a corollary to the "don't compete" rule, if the information is not distributed to investors or published on the data collector's own website, it is less likely that the website operator will consider the use to be competing.

7. To the extent the collected information is made available publicly or to investors:

   (a) Use as little of the website content as possible.

   The more copyrighted material is used, the stronger the website operator's argument is that the data collection has taken the economic value of the material.

   (b) Use factual information rather than more expressive content.

   Merely factual information does not receive copyright protection.

   (c) Do not copy the formatting or presentation of the information from the collected websites.

   In the United States, "thin" copyright protection is given to compilations that contain a modicum of originality in the selection and arrangement of factual information. Copying the formatting or presentation of information from a website gives the website operator the ability to argue that the protectable elements of its website have been infringed.

(d) Attempt to make the use of the website information "transformative."

A use is "transformative" when it alters the original with new expression, meaning or message. Merely copying and reposting website content does not "transform" the collected information and usually does not alter the purpose for which the website operator uses or provides it.

8. Use extra caution when information is collected from non-U.S. websites.

Under U.S. law, databases are not protected simply because they are time consuming and expensive to create, but in some countries databases are protected by copyright. Accordingly, if a given database required a substantial investment to put together, do not take the data on a systematic basis (at least without additional diligence) if the website is operated in a country that allows claims for database right infringement.

9. Think twice about continuing to collect in the face of a cease-and-desist letter.

Continuing to access a website after receipt of a cease-and-desist letter could give rise to a claim under the CFAA. At least one court has held that receipt of a cease-and-desist letter could constitute revocation of authorization such that continued access could give rise to a claim under the CFAA.

10. Consider obtaining a commercial license for the desired service.

Because there is little clarity on the enforceability of EULA terms against data collectors, in cases of doubt investment advisers should consider purchasing commercial licenses to desirable services.

D. Many investment managers do not directly engage in automated data collection, but instead buy data from third-party vendors who engage in the automated data collection. Before entering into such an arrangement, at a minimum, the manager should require the vendor to represent that it has complied with all laws and contractual obligations. In cases where the data and its continued future availability are critical to the manager, the manager may want to perform diligence to ensure that the vendor is in compliance with all the suggested steps listed above (II. C.).

III. The EU Safe Harbor Decision and New Regulations

A. In the late 1990s, both the United States and the EU began to enact data security/privacy legislation to protect the personal information of individuals that is collected and stored electronically by financial institutions.

1. The United States enacted the Gramm-Leach-Bliley Act and Regulation S-P, while the EU enacted the Data Protection Directive.[54]

2. While the United States and EU regulations cover the same topic, the two differ on the treatment of the sharing of individual personal data among affiliates in a corporate group.

(a) In the United States, affiliated groups of companies can share data among each other without getting individual customer approval for such sharing.

[54] Directive 95/46/EC, of the European Parliament and of the Council of 24 October 1995 on the Protection of Individuals with Regard to the Processing of Personal Data and on the Free Movement of Such Data.

(b) In the EU, an entity is required to obtain approval from a customer prior to sharing that customer's information with an affiliate or otherwise transferring the data outside the EU.

3. Under the EU Data Protection Directive, any U.S. entity doing business in an EU country through an EU subsidiary would need to obtain customer approval for the EU subsidiary to send EU customer data to its U.S. parent. In cases where a U.S. investment adviser with EU investors runs a global IT back office in New York or Connecticut, it was problematic to process the EU investor data.

B. In 2000, the EU Safe Harbor Decision[55] allowed U.S. institutions to transfer data between EU and U.S. affiliates if the U.S. institution self-certified as to its reasonable data security protections.

C. In October 2015, the EU's highest court determined that the United States is no longer trustworthy with regard to personal data of EU citizens.[56] The court based its decision on revelations by former National Security Agency contractor Edward Snowden regarding U.S. government data surveillance. After the court's decision, U.S. entities were no longer eligible for protection under the EU Safe Harbor Decision. Therefore, for example, an investment adviser with an IT back office in the United States and an affiliate in the EU would have to get approval from individual investors before transmitting and storing the investors' personal nonpublic data to and in its back office. Helpfully, prospective (i.e., advance) approval for affiliate data sharing is effective. Affected investment advisers should therefore review their subscription documents to see if they previously obtained EU investor approval for affiliate data sharing and data exportation.

D. Brand new rules adopted by the EU Parliament in December 2015 require, in this context, investor approval for data exportation to be "distinguish[ed] in their appearance from other matters" and given by the investor "after having been informed of the risks of such transfers."[57] This language seems to require separate (standalone) acknowledgment by EU investors to consent to data exportation. If this is the correct interpretation, a single investor signature on a lengthy subscription agreement would not be effective.

E. It is unclear whether the requirement of separate, distinguished consent will be retroactive so that advisers cannot rely on consent provisions contained in existing subscription documents. U.S. investment advisers with individual EU investors may need to go back and get separate consent from EU investors to export investor data to the United States.

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[55] Commission Decision 2000/520/EC of 26 July 2000 pursuant to Directive 95/46/EC of the European Parliament and of the Council on the adequacy of the protection provided by the safe harbor privacy principles and related frequently asked questions issued by the U.S. Department of Commerce (OJ 2000 L 215, p. 7), *available at* http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1451331724586&uri=CELEX:32000D0520.

[56] *Maximillian Schrems v. Data Protection Commissioner* [2015] Case C-362/14, ECLI:EU:C:2015, *available at* http://curia.europa.eu/juris/document/document.jsf?text=&docid=169195&pageIndex=0&doclang=en&mode=req&dir=&occ=first&part=1&cid=410849.

[57] European Commission, *Proposal for a Regulation of the European Parliament and of the Council on the Protection of Individuals with Regard to the Processing of Personal Data and on the Free Movement of Such Data (General Data Protection Regulation)*, at 45, COM (2012) 11 final (Jan. 25, 2012), *available at* http://ec.europa.eu/justice/data-protection/document/review2012/com_2012_11_en.pdf.

Co-Investments Today: Structures, Terms and Fiduciary Duties

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JANUARY 19, 2016

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David practices primarily in the areas of domestic and offshore hedge funds, including fund formations and restructurings. Additionally, he advises hedge fund managers on structure, compensation and various other matters relating to their management companies, and he structures seed-capital and joint venture arrangements. David also represents hedge fund managers in connection with SEC regulatory issues and compliance-related matters.

David is listed in *Chambers Global*, *Chambers USA*, *Expert Guide to the World's Leading Banking*, *Finance and Transactional Law Lawyers*, *The Legal 500 United States* and *Who's Who Legal: The International Who's Who of Private Funds Lawyers*. In particular, *Chambers USA* has noted that David is "an outstanding lawyer, with excellent judgment and the necessary soft touch during the delicate negotiations that occur during a start-up/ launch," and clients say "he is attuned to the business considerations and provides measured, reasoned advice that reflects his deep experience and industry knowledge." *The Legal 500 United States* has recognized him as "an extraordinarily capable attorney." A published author on subjects relating to investment management, David recently co-authored *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press). He also is a sought-after speaker for hedge fund industry conferences and seminars, and a frequent guest lecturer at New York-area law and business schools. He most recently presented on current trends with emerging managers in a prime brokerage (consulting services) presentation, and on product and marketing strategies for growth for hedge fund COOs and CFOs.

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Omoz focuses his practice on the representation of sponsors and investors in the formation and structuring of private equity funds, hedge funds and hybrid funds. He has extensive experience representing sponsors and investors on funds employing real estate, buyout, credit, distressed investment, structured products, activist, multi-strategy and long-short equity strategies. He also represents hedge fund managers and investors in the negotiation of seed-capital transactions, and he advises sponsors of private equity firms in the structuring of complex carry-sharing arrangements among principals and employees. Omoz's recent representations include institutional sponsors and boutique firms in the formation of private equity funds, hedge funds and hybrid funds; lead investors on their investments in private equity funds; hedge fund managers and investors in seed-capital arrangements; investment managers in joint venture arrangements; and investment managers and investors in the formation of special purpose acquisition and co-investment vehicles.

Omoz is recognized as a leading lawyer by *The Legal 500 United States*. He regularly addresses investment managers about current developments relating to private investment funds, and his recent speaking engagements have addressed market terms and regulatory issues surrounding co-investments, market updates for private equity funds and trading compliance. He is a contributor to the *Fund Formation and Incentives Report* (SRZ in association with Private Equity International).

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Phyllis is a partner in the New York office, where she focuses her practice on the structuring, formation and operation of private equity funds, including buyout funds, venture capital funds, mezzanine funds, distressed funds and real estate funds. She represents both fund sponsors and investors in her practice. In addition to assisting fund sponsors with their internal management arrangements, succession planning and the creation of internal investment and co-investment vehicles, she has extensive experience with institutional investors and regularly advises clients on market terms of investment funds. Phyllis also advises private equity funds in connection with their investments in, and disposition of, portfolio companies.

Phyllis is recognized as a leading practitioner in her field by numerous independent publications, including *The Legal 500 United States*, *The Best Lawyers in America*, *Who's Who Legal: The International Who's Who of Private Funds Lawyers*, *Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers* (Investment Funds, Private Equity) and *Expert Guide to the World's Leading Women in Business Law* (Investment Funds). A member of New York's Private Investment Fund Forum, Phyllis frequently shares her insights on effective fund formation strategies at industry conferences and seminars. She recently discussed compliance concerns for co-investments, and conflicts of interest and other ethics issues for private equity fund managers. Phyllis is also the co-author of *Private Equity Funds: Formation and Operation* (Practising Law Institute), which is considered the leading treatise on the subject, and contributed to *Fund Formation and Incentives Report* (SRZ in association with Private Equity International) as well as a chapter on "Advisers to Private Equity Funds — Practical Compliance Considerations" to *Mutual Funds and Exchange Traded Funds Regulation, Volume 2* (Practising Law Institute).

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Co-Investments Today: Structures, Terms and Fiduciary Duties

I. What Constitutes a Co-Investment, and When Do Co-Investment Opportunities Arise?

A. A co-investment opportunity is an opportunity to invest alongside a private investment fund, typically on a discretionary basis.

B. Co-investments have historically been utilized by private equity funds, but the relevance and use of co-investments alongside hedge funds has grown.

1. Co-investment opportunities offered by hedge funds can be traced to the reduced use of side pockets. Even where hedge funds include side pockets, investors today often may opt out of side-pocket investments. Therefore, other than small amounts of illiquid investments that can be pursued through the primary fund vehicle, a hedge fund manager targeting illiquid investments often does so through a separate co-investment structure outside its main fund.

2. Co-investment opportunities are generally perceived by managers and investors as enhancements to the participation of investors in a primary fund, although the Securities and Exchange Commission ("SEC") has identified conflicts associated with co-investments.

C. Reasons for which hedge funds offer co-investment opportunities, in addition to pursuing illiquid investments, include:

1. Generating goodwill/building stronger relationships with existing or prospective investors and other strategic parties (such as financing sources, deal sources, or other parties who offer administration, servicing or other expertise):

   (a) Investors seek co-investment opportunities because co-investment fee terms are typically lower than those of the primary fund.

   (b) Access to a manager's "high conviction" ideas (i.e., larger positions related to a manager's conviction in the investment) could improve investor relations.

2. Enabling the manager to close an investment that the primary fund is unable to pursue due to:

   (a) Limited capital available to the primary fund (which is the basis for referring to co-investment entities as "overflow" entities);

   (b) Limitations on investment parameters applicable to the primary fund, such as diversification limits on geography, industry, asset-class or sector (including, as stated above, illiquid investments); and/or

   (c) Constraints presented by pending or potential withdrawals.

3. Enabling the manager to acquire control or influence in a target as part of an activist strategy or in a restructuring or pre-bankruptcy;

4. Spreading risk between the primary fund and co-investors;

5. Allowing a manager to build a track record in strategies that are not core to the primary hedge fund.

D. Co-investment opportunities are offered at various times, generally subsequent to the formation of the primary fund, on an ad hoc basis, when it is determined that the primary fund will not pursue the entire investment.

1. It has become more common for a vehicle to be established for an investor at the time that investor makes its investment in the main fund to facilitate future co-investing, particularly where the investor has approved soft commitments for funding co-investment opportunities that become available.

2. Co-investment funds are also being established to allow investors in the co-investment fund to participate in co-investments with unrelated investment funds.

3. The allocation of co-investment opportunities represents a potential conflict for the manager:

(a) If a co-investment vehicle is established subsequent to the formation of the primary fund, the manager must consider at the time an investment is made whether the primary fund can accommodate a particular investment before an investment can be directed to a co-investment vehicle.

(b) If a co-investment vehicle is established at the same time as the formation of the primary fund, before co-investments are made by such vehicle, the manager should assess what fiduciary and other duties it has to the investors in the co-investment vehicle.

II. Structures for Implementing Co-Investments

A. Basic Options

1. Separate "structure" overseen and controlled by the manager of the primary fund, including by way of:

(a) A managed account;

(b) A fund-of-one for a specific investor;

(c) An investment vehicle set up for multiple investors (i.e., a co-investment fund); or

2. A direct investment in the target by the co-investor.

The manager may consider whether it should have a power of attorney or proxy from investors investing directly into the target to ensure that such investors and the primary fund exercise rights consistently with respect to the investment. This may be achieved through voting or similar agreement that gives the manager control.

B. The structure to be used will depend on a number of factors, including, among others:

1. Whether the structure is for one or more investors; and

2. The tax or regulatory status of the particular investors.

   Investors may present limitations depending on whether they are taxable, tax-exempt, U.S. or non-U.S.; and whether they are subject to certain statutes or rules that may limit their participation (e.g., BHCA, Investment Company Act, ERISA or antitrust rules).

III. Terms of Co-Investments and Co-Investment Vehicles

A. The terms upon which co-investments are made and exited will depend on a number of factors:

   1. Typically, investments by the co-investor will be made and exited on the same terms as the primary fund, subject to tax or regulatory considerations.

      Co-investors and investors in the primary fund should be advised if co-investors are investing or may in the future invest on different terms. With proper disclosure, it should be possible for the primary fund and the co-investment vehicle to exit at different times and on different terms.

   2. Follow-on investments in the same company may not, however, be made pro rata by the primary fund and co-investors.

      (a) Either or both of the primary fund and co-investors may have capital constraints or other objectives that limit their ability to make additional investments in the original issuer.

      (b) If follow-on investments are made on different terms, or if the primary fund and the co-investors make a follow-on investment and the other does not, the primary fund and co-investment vehicle are likely to recognize different returns on their investments in the same investment.

B. The term and conditions of the co-investment vehicles established to make illiquid investments will typically be similar to private equity fund terms, although the term of a co-investment vehicle is typically shorter than the term of a typical private equity fund.

   1. For example, the term of a co-investment vehicle that co-invests with an activist fund is typically three years (subject to extensions), including a one-year investment period followed by a two-year harvest period, and the term of a credit-oriented vehicle is typically four years (subject to extensions), including a one-year commitment period and a three-year harvest period.

   2. Co-investors may seek direct private equity-type rights, including:

      (a) Pre-emptive rights (i.e., right to make follow-on investments in the portfolio company);

      (b) Access to the information provided by the portfolio company, such as financial statements of the portfolio company;

      (c) Access to management of the portfolio company; and

      (d) Co-sale rights/drag rights.

C. Generally, the economic terms of co-investment structures and vehicles differ from those of the primary fund.

1. The carried interest, if paid at all, will be paid upon realization of the entire investment and is likely to be less than 20 percent; management fees may not be charged at all to co-investors. Generally, both are lower than that charged to investors in the primary fund.

2. Whether carry and management fees are charged depends in part on whether the fund manager needs the co-investors' capital to close the deal (i.e., if the primary fund has insufficient capital, taking into account risks, policies and investment restrictions).

    (a) If the fund manager needs the co-investors' capital to close the deal, it will charge little or no fees or carried interest to co-investors; or

    (b) When co-investments are in liquid or quasi-liquid investments and using co-investors' capital is not necessary to close the deal (though it may result in the manager managing a larger position), fees and carry are much more likely to be charged. In such circumstances, the carry charged to co-investors may be the same or less than that charged by the primary fund (e.g., 20 percent or less) while management fees will typically be lower than the level charged by the primary fund.

3. Other factors considered in determining the fee terms applicable to a given co-investor may include:

    (a) Whether the co-investor is a current fund investor (in which case the investor will generally seek to leverage its existing investment and pay lower fees);

    (b) The size of the potential investment by the co-investor (generally, the larger the investor, the lower the fee);

    (c) The importance of the co-investor (e.g., the co-investor may be investing a small amount but may be a large established institutional investor active in investing within the particular strategy or with whom the manager desires to cultivate or develop a more extensive relationship); and

    (d) Time sensitivity of the co-investment opportunity.

4. Expenses

    (a) The co-investment structure will bear its pro rata portion of all investment-related expenses and bear its own expenses.

    (b) Depending on whether the co-investment structure is offered simultaneously with, or subsequent to, the primary fund, co-investors may be responsible for broken-deal expenses (following their approval of the deal). In newer funds, managers may also have negotiated for the primary fund to be responsible for broken-deal expenses of co-investors. Unless clearly disclosed in fund documentation, broken-deal costs cannot be borne by the primary fund (this latter point has been and continues to be an area of focus for the SEC).

    (c) Managers must consider how expenses of co-investment vehicles will be paid if the underlying investment is illiquid.

5. Confidentiality

   Especially with respect to investments in publicly traded securities, the manager must consider issues related to material nonpublic information and ensure that co-investors are restricted from trading and subject to confidentiality undertakings.

6. Depending on the structure used, co-investment structures raise the same legal and regulatory issues as other accounts, including issues under the securities laws, ERISA and filings obligations (including Schedule 13D filings).

IV. How to Select Co-Investors

A. When the fund needs co-investors to close an investment, the best-suited type of investor generally is an institutional investor and has:

   1. Experience in underwriting the particular type of investment; and

   2. The ability to move fast in decision-making and funding.

B. If a general partner is seeking to syndicate an investment, it may not be necessary to seek capital from institutional investors who understand the underlying asset being purchased.

C. Investors may seek co-investment rights through side letters as part of their decision to invest in the primary fund, and the manager must determine the type of commitment that it can offer to such investors.

   1. Often, a side-letter provision contains the manager's simple acknowledgement of the investor's interest in making co-investments, and does not create any duty of the manager.

   2. Other side letters contain affirmative co-investment rights, where the investor may be given the right to take up a pro rata share of co-investment opportunities offered to other investors of the same primary fund.

   3. It is customary for a manager to be able to offer co-investments to strategic investors (e.g., deal sources and financing sources) without sharing such arrangement with investors in the primary fund.

D. Conflicts in Selecting Co-Investors: SEC Focus

   1. The SEC has in recent years identified conflicts of interest as a significant concern in its examinations of private fund advisers, as noted by Julie Riewe (co-chief of the Asset Management Unit of the SEC's Enforcement Division) in her speech "Conflicts, Conflicts Everywhere."

   2. While some conflicts are obvious — like personal trading in the same securities that clients are trading in — others are more nuanced. The SEC's examination staff has recently been focusing more on allocations of investment opportunities and which parties have been offered co-investment opportunities.

   3. In a series of presentations and speeches, the SEC's examination staff and OCIE leadership have highlighted concerns with co-investments — namely concerns over whether investors given co-investment rights were favored over other investors and whether disclosure had been provided to investors.

(a) At the SEC COO Outreach Program in January 2014, the SEC staff raised a concern of "favoring certain clients or funds or favoring certain investors without proper disclosure," cited "co-investment allocation" as an example of favoritism, and went on to state that "Rule 206(4)-8 of the Advisers Act and other antifraud provisions might be violated without adequate disclosure." The speakers recommended that advisers let their investors know on what basis and when co-investment opportunities would be offered, so that investors may have an opportunity to "complain" about the adviser's process.

(b) In May 2014, Andrew Bowden (then director of OCIE) noted that the governing documents of funds that the SEC had reviewed often lacked, among other things, "protocols for mitigating conflicts of interest in connection with co-investment allocations."

(c) In May 2015, current OCIE Director Marc Wyatt said:

"[W]e have detected several instances where investors in a fund were not aware that another investor negotiated priority co-investment rights. Disclosing this information is important because co-investment opportunities have a very real and tangible economic value but also can be a source of various conflicts of interest";

...

"Ironically, many in the industry have responded to our focus by disclosing less about co-investment allocation rather than more under the theory that if an adviser does not promise their investors anything, that adviser cannot be held to account. However, the risk in that approach is that such promises are often made anyway, either orally or through email. I believe that the best way to avoid this risk is to have a robust and detailed co-investment allocation policy which is shared with all investors. To be clear, I am not saying that an adviser must allocate its co-investments pro-rata or in any other particular manner, but I am suggesting that all investors deserve to know where they stand in the co-investment priority stack."

V. Compliance Policies and Procedures

A. Reviewing and updating investor disclosures with respect to co-investments is critical. Generic disclosure as to the possibility of co-investments may be insufficient where there are significant co-investment opportunities offered to some, but not all, fund investors.

1. Disclosures with respect to co-investment opportunities should be consistent with side letters, offering documents, contents of Form ADV and DDQ responses.

2. Compliance policies and procedures should be tailored to the specific circumstances of the business.

   To be "robust and detailed," a co-investment policy should identify who makes the determinations with respect to co-investment allocations, the basis on which such determinations may be made, and the process for contemporaneously documenting the basis for co-investment allocations. The determination as to the fund's optimal investment size is typically an important part of this process.

3. The SEC examination staff seems particularly focused on prior agreements or commitments to provide co-investment opportunities. Any such commitments — whether "hard" or "soft" — should be identified and factored into policies and disclosures.

4. Compliance review of co-investment allocations should be incorporated into the regular testing program.

B. Co-investment vehicles formed by a manager are generally a "client."

1. Disclosure in Form ADV would include managed co-investment vehicles (depending on the structure of the co-investment vehicle).

2. Custody rules must be satisfied, and therefore, the manager may need to have the financial statements of co-investment vehicles audited.

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Private Equity

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Stephanie is co-head of Schulte Roth & Zabel's Investment Management Group and a member of the firm's Executive Committee. Her practice includes investment management, partnerships and securities, with a focus on the formation of private equity funds (LBO, mezzanine, distressed, real estate, venture) and liquid-securities funds (hedge funds, hybrid funds) as well as providing regulatory advice to investment managers and broker-dealers. She also represents fund sponsors and institutional investors in connection with seed-capital investments in fund managers and acquisitions of interests in investment management businesses, and she represents funds of funds and other institutional investors in connection with their investment activities.

Recently named chair of the Private Investment Funds Subcommittee of the International Bar Association, Stephanie is a founding member and former chair of the Private Investment Fund Forum, a member of the Advisory Board of Third Way Capital Markets Initiative, a member of the board of directors of 100 Women in Hedge Funds, a member of the Board of Visitors of Columbia Law School and a member of the board of directors of the Girl Scouts of Greater New York. She is listed in *Chambers USA*, *Chambers Global*, *IFLR1000*, *The Legal 500 United States*, *Best Lawyers in America*, *Who's Who Legal: The International Who's Who of Business Lawyers* (which ranked her one of the world's "Top Ten Private Equity Lawyers"), *Who's Who Legal: The International Who's Who of Private Funds Lawyers* (which ranked her at the top of the world's 2014 "Most Highly Regarded Individuals" list), *Expert Guide to the Best of the Best USA*, *Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers*, *Expert Guide to the World's Leading Women in Business Law* and *PLC Cross-border Private Equity Handbook*, among other leading directories. Stephanie was named the "Private Funds Lawyer of the Year" at the 2014 Who's Who Legal Awards and the Euromoney Legal Media Group's "Best in Investment Funds" at the inaugural Americas Women in Business Law Awards. She is also recognized as one of *The Hedge Fund Journal*'s 50 Leading Women in Hedge Funds and was named one of the 2012 Women of Distinction by the Girl Scouts of Greater New York. She is a much sought-after speaker on fund formation and operation and compliance issues, and she regularly publishes articles on the latest trends in these areas. Stephanie co-authored *Private Equity Funds: Formation and Operation* (Practising Law Institute) and *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press), contributed a chapter on "Hedge Fund Investment in Private Equity" for inclusion in *PLC Cross-border Private Equity Handbook 2005/06* (Practical Law Company) and a chapter on "Advisers to Private Equity Funds — Practical Compliance Considerations" for *Mutual Funds and Exchange Traded Funds Regulation, Volume 2* (Practising Law Institute), and wrote *New York and Delaware Business Entities: Choice, Formation, Operation, Financing and Acquisitions* (West) and *New York Limited Liability Companies: A Guide to Law and Practice* (West).

Stephanie earned her J.D. from Columbia University School of Law, where she was a Harlan Fiske Stone Scholar, and her B.A., *cum laude*, from Harvard University.

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Marc E. Elovitz

Marc is the chair of Schulte Roth & Zabel's Investment Management Regulatory & Compliance Group. He advises private fund managers on compliance with the Investment Advisers Act of 1940 and other federal, state and self-regulatory organization requirements, including establishing compliance programs, registering with the SEC and CFTC, and on handling SEC and NFA examinations. Marc provides guidance to clients on securities trading matters and represents them in regulatory investigations and enforcement actions, arbitrations and civil litigation. He also regularly leads training sessions for portfolio managers, analysts and traders on complying with insider-trading and market manipulation laws, and he has developed and led compliance training sessions for marketing and investor relations professionals. Marc works closely with clients undergoing SEC examinations and responding to deficiency letters and enforcement referrals. He develops new compliance testing programs in areas such as trade allocations and conflicts of interest, and he leads macro-level compliance infrastructure reviews with fund managers, identifying the material risks specific to each particular firm and evaluating the compliance programs in place to address those risks.

Marc is frequently invited to discuss current industry-related topics of interest at leading professional and trade association events. He most recently presented on whistleblowing, regulatory and compliance issues for private funds, and SEC inspections and examinations of hedge funds and private equity funds. *The Legal 500 United States*, *Who's Who Legal: The International Who's Who of Private Funds Lawyers* and *New York Super Lawyers* have recognized Marc as a leading lawyer in his field. He is a member of the Steering Committee of the Managed Funds Association's Outside Counsel Forum, the American Bar Association's Hedge Funds Subcommittee and the Private Investment Funds Committee of the New York City Bar Association. Marc recently co-authored "Securities, Futures Regulators Increase Scrutiny, Expectations on Cybersecurity" in *Bloomberg Brief — Financial Regulation* and "Rule 105 Update: New Round of Enforcement Highlights SEC Approach on Short-Selling Violations" in *The Hedge Fund Journal*. He is also a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press), the "Protecting Firms Through Policies and Procedures, Training, and Testing" chapter in the *Insider Trading Law and Compliance Answer Book* (Practising Law Institute) and the "Market Manipulation" chapter in the leading treatise *Federal Securities Exchange Act of 1934* (Matthew Bender). He also wrote the chapter on "The Legal Basis of Investment Management in the U.S." for *The Law of Investment Management* (Oxford University Press).

Marc received his J.D. from New York University School of Law and his B.A., with honors, from Wesleyan University.

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David focuses on complex commercial litigation and regulatory matters primarily for financial services industry clients, including hedge funds, funds of funds and private equity funds. He has substantial experience in both private securities litigation and securities regulatory matters, investigations by the U.S. Securities and Exchange Commission, the New York Stock Exchange, the Financial Industry Regulatory Authority and state attorneys general offices, investor disputes and class action litigation. David also provides day-to-day counseling for financial services companies on these issues. His significant engagements include successfully representing investment managers in connection with regulatory investigations into trading activities; an interdealer broker in various arbitrations and related civil actions arising from the hiring of brokers by a competitor; an investment manager in connection with the wind-up of funds and related U.S.- and Cayman Island-based litigation, as well as related state and federal regulatory investigations; and a group of investment managers and related entities in fraudulent conveyance actions arising from leveraged buyout transactions.

David has written extensively on securities regulation and frequently presents on regulatory compliance and enforcement issues. In addition to participating in firm-sponsored seminars and workshops and authoring client alerts, he is the co-author of “Rule 105 Update: New Round of Enforcement Highlights SEC Approach on Short-Selling Violations” in *The Hedge Fund Journal* and the author of the “Big Boy Letters” chapter in the *Insider Trading Law and Compliance Answer Book* (Practising Law Institute). He spoke recently on topics including insider trading, SEC examinations and compliance issues for private investment funds.

David was awarded his J.D. from Boston University School of Law, where he was a G. Joseph Tauro Scholar and an Edward F. Hennessey Scholar, and his B.A. from Boston University.

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Jacob focuses his practice on counseling commodity pool operators, commodity trading advisors, other commodity professionals and private investment fund managers on operational, regulatory and compliance matters. He regularly advises hedge and private equity fund managers with respect to futures and swaps trading; the U.S. Commodity Futures Trading Commission's (CFTC) exemptions, registration and reporting requirements; and compliance with the requirements of the National Futures Association, as well as CFTC and exchange rules concerning OTC and listed derivatives. Jacob conducts training sessions with respect to regulatory compliance matters and helps guide firms through regulatory examinations. He also has expertise in the formation and ongoing operational needs of hedge funds and other private investment funds and provides guidance on a variety of regulatory, compliance and risk management issues related to the implementation of the Dodd-Frank Act. Jacob joined Schulte Roth & Zabel from the CFTC, where he served most recently as Special Counsel in the Division of Swap Dealer and Intermediary Oversight. At the CFTC, he drafted new regulations and worked on a broad range of matters relating to CFTC registration and compliance.

Jacob has spoken at a series of SRZ workshops and seminars on CFTC registration, NFA examinations, trade compliance and hedge fund and management company structures, and he contributed to *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press). He recently co-authored "CFTC's Position on Bitcoin — and What It Means" in *Law360*, "JOBS Act Update: CFTC Relief Removes Impediment to General Solicitation" in *The Hedge Fund Journal* and the SRZ publication "The CFTC Brings (and Settles) Its First Insider-Trading Case: Implications for All Private Fund Managers."

Jacob earned both his J.D. and M.B.A. degrees from Fordham University and received *cum laude* honors from the Fordham University Graduate School of Business. He received his B.A., *cum laude*, from Brooklyn College.

Recent Examinations: Substantive Areas of Regulatory Focus

I. SEC and NFA Examinations and Enforcement Actions

A. In General: The SEC and NFA have expanded their examination programs in an effort to encompass the influx of advisers to private funds that are newly required to register pursuant to the Dodd-Frank Act. The SEC's Office of Compliance Inspections and Examinations ("OCIE") has developed new types of examinations and implemented new technologies to select advisers for examination and to aid the SEC staff in conducting examinations. OCIE has also hired personnel from the private sector and has been able to conduct more probing reviews of many private fund managers. The increasingly robust nature of SEC examinations, combined with a greater willingness by the OCIE staff to refer cases to the SEC's Division of Enforcement, has created an increased enforcement risk for private fund managers undergoing an SEC examination. Like the SEC, the NFA also expanded its examination program to handle the influx of newly registered CPOs and CTAs. While the NFA historically attempted to examine every member at least once every three years, that has proven difficult over the past few years, given the influx of new members. The NFA, however, appears to have reached appropriate staffing levels, resulting in many new members having recently gone through their first examination.

1. Risk-Based Examinations: Many recent examinations have been conducted on a "risk" basis, meaning that OCIE staff has analyzed data regarding the manager and funds, and has chosen the manager for examination based on perceived risks. With the aid of sophisticated new technologies, OCIE is able to more carefully and objectively prioritize advisers for examination. The NFA has also used new risk-based tools to determine which members should be examined on a non-routine basis. The NFA will look at factors such as customer complaints, habitually late filings and "red flags" in the periodic reports submitted to the NFA (i.e., Form CPO-PQR and pool financial statements).

2. Examinations for "Cause": Examinations for cause have continued to constitute a significant component of reviews of private fund managers. Whether such examinations are instigated by a potential whistleblower or by other tips, complaints or referrals ("TCRs"), these examinations are particularly sensitive because the examination staff may come in with an expectation of finding wrongdoing.[1]

B. Expenses

1. In General: Many recent examinations of both private equity and hedge fund managers have focused on the allocation of expenses, both between manager and funds, and between funds. Common deficiencies related to expense allocations have included: (1) over-allocating expenses to one client where another client will not pay such expenses (e.g., a managed account client won't pay for "broken-deal" expenses and the fund client therefore pays the full amount); and (2) charging expenses to the fund that are not clearly disclosed to investors (e.g., certain consultant expenses). Examination staff have been aggressively drilling down on expense allocations even where the amounts are de minimis. In addition, many examiners have requested that the manager itself conduct a thorough review of all expenses charged to clients. In anticipation of such scrutiny, many managers have conducted those reviews prior to examination and made remediation to affected funds where appropriate.

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[1] Carlo V. di Florio, Director, Office of Compliance Inspections and Examinations, Speech by SEC Staff: Remarks at the Compliance Outreach Program, Washington, D.C. (Jan. 31, 2012), *available at* www.sec.gov/News/Speech/Detail/Speech/1365171489758.

2. KKR: On June 29, 2015, the SEC initiated, and settled, cease-and-desist proceedings against Kohlberg Kravis Roberts & Co. LP ("KKR") in connection with misallocation of expenses related to unsuccessful buyout opportunities ("broken deal expenses"). This was "the first SEC case to charge a private equity adviser with misallocating broken deal expenses."[2] KKR advises and manages its "flagship" private equity funds, along with co-investment vehicles. The limited partnership agreement for KKR's largest fund, the KKR 2006 Fund LP ("2006 Fund") allowed KKR to allocate broken deal expenses "incurred by or on behalf of" the 2006 Fund. According to the SEC, however, KKR did not also allocate the broken deal expenses to the co-investment vehicles and did not disclose the disparate treatment. As a result, KKR misallocated broken deal expenses of $17.4 million to the flagship funds.

3. Blackstone: On Oct. 7, 2015, the SEC initiated, and settled, cease-and-desist proceedings against Blackstone Management Partners LLC, Blackstone Management Partners III LLC, and Blackstone Management Partners IV LLC (collectively, "Blackstone"). These proceedings arose from alleged inadequate disclosures that involved two distinct breaches of fiduciary duty.[3] First, from at least 2010 through March 2015, upon either the private sale of a portfolio company or an initial public offering ("IPO"), Blackstone terminated certain portfolio company monitoring agreements and accelerated the payment of future monitoring fees as set forth in the agreements. Although Blackstone disclosed that it may receive monitoring fees from portfolio companies held by the funds it advised, and disclosed the amount of monitoring fees that had been accelerated following the acceleration, Blackstone failed to disclose to its funds, and to the funds' limited partners prior to their commitment of capital, that it may accelerate future monitoring fees upon termination of the monitoring agreements. Second, in late 2007, Blackstone negotiated a single legal services arrangement with its primary outside law firm (the "Law Firm") on behalf of itself and the funds. For the majority of legal services performed by the Law Firm beginning in 2008 and continuing through early 2011, Blackstone received a discount that was substantially greater than the discount received by the funds. The disparate legal fee discounts were not disclosed to the funds or the funds' limited partners until August 2012. Because of its conflict of interest as the recipient of the accelerated monitoring fees and the beneficiary of the disparate legal fee discounts, Blackstone could not effectively consent to either of these practices on behalf of the funds it advised. As a result, Blackstone breached its fiduciary duty to the funds in violation of Section 206(2) of the Advisers Act and also violated Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder.

4. Cherokee: On Nov. 5, 2015, the SEC initiated, and settled, cease-and-desist proceedings against Cherokee Investment Partners LLC ("CIP") and Cherokee Advisers LLC ("CA") (collectively referred to as "Cherokee") in connection with the alleged improper allocation to client funds (the "Cherokee Funds") of certain consulting, legal and compliance-related expenses.[4] Between July 2011 and March 2015, CIP and CA incurred consulting, legal and compliance-related expenses in the course of preparing for registration as an investment adviser under the Advisers Act, complying with legal obligations arising from registration and responding to the OCIE staff and the staff of the Commission's Division of Enforcement. Cherokee allocated to the Cherokee Funds, and caused the Cherokee Funds to pay for, $455,698 of these expenses. Although the Cherokee Funds' limited partnership agreements disclosed that the Cherokee Funds would be charged for expenses that in the good faith judgment of the general partner arose out of the operation and activities of the

[2] Press Release, Securities and Exchange Commission, SEC Charges KKR with Misallocating Broken Deal Expenses (June 29, 2015), *available at* www.sec.gov/news/pressrelease/2015-131.html.

[3] *In the Matter of Blackstone Management Partners L.L.C., Blackstone Management Partners III L.L.C., and Blackstone Management Partners IV L.L.C.*, Release No. IA-4219, Securities and Exchange Commission (Oct. 7, 2015).

[4] *In the Matter of Cherokee Investment Partners, LLC and Cherokee Advisers, LLC*, Release No. IA-4258, Securities and Exchange Commission (Nov. 5, 2015).

Cherokee Funds, including the legal and consulting expenses of the Cherokee Funds, there was no disclosure that the Cherokee Funds would be charged for the advisers' legal and compliance expenses. As a result, CIP and CA allegedly breached their fiduciary duties to the Cherokee Funds in violation of Section 206(2) of the Advisers Act and also allegedly violated Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder.

5. Cranshire: On Nov. 23, 2015, the SEC initiated, and settled, cease-and-desist proceedings against Cranshire Capital Advisors, LLC ("CCA") in connection with alleged negligent allocation of compliance-related expenses to a private fund client of CCA (the "CCA Fund").[5] From 2012 through 2014, CCA employed an outside attorney to serve as a compliance consultant to advise it on registration and compliance matters. The services provided by the consultant related to the creation and operation of CCA's compliance program rather than any investments or operations of the CCA Fund. During this period, CCA improperly used $158,650 in CCA Fund assets to pay the consultant's fees in a manner that was not disclosed in the CCA Fund's organizational documents. The CCA Fund's private placement memorandum and limited partnership agreement both disclosed that CCA would "provide the [CCA Fund] with office space and utilities. The [CCA Fund] will pay all its other expenses, including … legal and accounting fees." Similarly, an Omnibus Management Agreement covering the CCA Fund (the "Management Agreement") provided that CCA would render its services to the CCA Fund "at its own expense, including, without limitation, operating expenses (such as rent for office space and telephone lines) … unless such expenses are otherwise expenses to be borne by the Funds as described above." Regarding legal and compliance expenses, the Management Agreement stated only that "each Fund shall bear its own expenses, including … external legal expenses." The SEC found that none of these provisions authorized CCA to charge the CCA Fund for its own compliance consulting fees. As a result, CCA allegedly breached its fiduciary duty to the CCA Fund in violation of Section 206(2) of the Advisers Act and also allegedly violated Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder.

C. Conflicts and Disclosures (Including Marketing)

1. In General: In the past year, many government enforcement efforts with respect to private funds have also centered on conflicts of interest, as forewarned by Julie Riewe, co-chief of the Asset Management Unit of the SEC's Division of Enforcement, in her February 2015 speech, "Conflicts, Conflicts Everywhere."[6] Riewe made the following related points in her speech:

(a) The SEC staff are examining, at least in part, whether advisers are discharging their fiduciary obligation "to identify [their] conflicts of interest and either (1) eliminate them, or (2) mitigate them and disclose their existence to boards or investors." Advisers should ask the following questions:

(i) For each conflict identified, as a threshold matter, can the conflict be eliminated? If not, why not?

(ii) As to mitigation, are the firm's policies and procedures reasonably designed to address the conflicts the firm has identified, and are they properly implemented?

(iii) As to written disclosure, has the firm reviewed, and does the firm review regularly, all of the relevant disclosure documents to ensure that all conflicts are disclosed, and disclosed

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[5] *In the Matter of Cranshire Capital Advisors*, LLC, Release No. IA-4277, Securities and Exchange Commission (Nov. 23, 2015).

[6] Securities and Exchange Commission, *Conflicts, Conflicts Everywhere – Remarks to the IA Watch 17th Annual IA Compliance Conference: The Full 360 View*, Washington, D.C. (Feb. 26, 2015), *available at* www.sec.gov/news/speech/conflicts-everywhere-full-360-view.html.

in a manner that allows clients or investors to understand the conflict, its magnitude and the particular risk it presents?

(b) The SEC staff expect to recommend a number of conflicts cases for enforcement action, including matters involving best execution failures, undisclosed outside business activities, related-party transactions, fee and expense misallocation issues, undisclosed bias toward proprietary products and investments, and conflicts presented by advisers using the fund's assets to grow the fund and, consequently, the adviser's own fee.

2. BlackRock: In April 2015 the SEC instituted a settled administrative proceeding against BlackRock Advisors LLC ("BlackRock"), alleging that BlackRock breached its fiduciary duty to its clients by failing to disclose a conflict of interest.[7] BlackRock portfolio manager Daniel J. Rice III, who managed energy-focused funds, founded Rice Energy, an oil and natural gas company, of which Rice was the general partner and in which Rice invested $50 million of his own money. Rice Energy formed a joint venture with a publicly traded coal company; that joint venture eventually became the largest holding in BlackRock's Energy & Resources Portfolio, which was managed by Rice. The SEC alleged that BlackRock knew and approved of Rice's involvement in the joint venture, but failed to disclose the conflict of interest to the boards of the registered funds or advisory clients. Blackrock was charged with certain violations of the Investment Advisers Act of 1940 (the "Advisers Act") that do not require scienter.

3. JP Morgan: On Dec. 18, 2015, the CFTC issued an order filing and settling charges against JPMorgan Chase Bank, N.A. ("JPMCB").[8] The CFTC found that JPMCB failed to disclose certain conflicts of interest to clients of its U.S.-based wealth management business, J.P. Morgan Private Bank. Specifically, JPMCB failed to fully disclose its preference for investing its client funds in certain commodity pools or exempt pools, namely hedge funds and mutual funds managed and operated by an affiliate and subsidiary of JP Morgan Chase & Co. JPMCB also failed to disclose its preference for investing its clients' funds in third-party-managed hedge funds, each a commodity pool or exempt pool, that shared management and/or performance fees with a JPMCB affiliate. Aitan Goelman, the CFTC's Director of Enforcement, commented that "Investors are entitled to know if a bank managing their money favors placing investments in its own proprietary funds or other vehicles that generate fees for the bank."

4. Guggenheim: In another matter highlighting the SEC staff's focus on conflicts of interest issues, the SEC brought charges in August 2015 against Guggenheim Partners Investment Management LLC ("Guggenheim"), an investment adviser that provides investment management services primarily to institutional clients, high-net-worth individuals and private funds.[9] The SEC alleged that a senior Guggenheim executive obtained a loan from an advisory client in July 2010. The next month, the same executive invested both that client and other clients in two transactions, but did so on different terms for the client from whom he had obtained the loan. The SEC alleged that although senior officials at Guggenheim were aware of the loan, none of them informed the company's compliance staff, nor was the loan disclosed to the other advisory clients. As noted by Andrew J. Ceresny, Director of the SEC Division of Enforcement, "As fiduciaries, investment advisors must be vigilant about disclosing all material facts to their clients, including actual and potential conflicts of

[7] Press Release, Securities and Exchange Commission, SEC Charges BlackRock Advisors with Failing to Disclose Conflict of Interest to Clients and Fund Boards (April 20, 2015), *available at* www.sec.gov/news/pressrelease/2015-71.html.

[8] Press Release, Commodity Futures Trading Commission, CFTC Orders JPMorgan Chase Bank, N.A. to Pay $100 Million for Failure to Disclose Conflicts of Interest (Dec. 18, 2015), *available at* www.cftc.gov/PressRoom/PressReleases/pr7297-15.

[9] Press Release, Securities and Exchange Commission, Guggenheim Partners Investment Management LLC Settles Charges It Failed to Disclose Conflict to Clients (Aug. 10, 2015), *available at* www.sec.gov/news/pressrelease/2015-162.html.

interest."[10] Guggenheim was charged with certain violations of the Advisers Act that do not require scienter.

5. Reliance: In December 2014, the SEC brought a litigated administrative proceeding, in which it alleged scienter-based fraud charges against Reliance Financial Advisers ("Reliance") and its two co-owners, alleging that the firm made false and misleading statements to clients when recommending investments in a risky hedge fund. The SEC alleged that Reliance encouraged clients to invest in the Prestige Fund, a hedge fund managed by Scott Stephan. Although Stephan had virtually no hedge fund investing experience, Reliance allegedly disseminated materials claiming that the fund was an appropriate investment for retirees living on fixed incomes or for those nearing retirement. The Prestige Fund's trading strategy was described to prospective investors as being fully automatic and governed by a computer algorithm. The Prestige Fund collapsed after losing 80 percent of its value as a result of Stephan manually placing trades, contrary to the automated trading strategy marketed to investors. In a statement, Andrew Calamari, director of the SEC's New York Regional Office, argued that Reliance's co-owners violated their fundamental duty of complete candor "by peddling a hedge fund investment that was more risky than depicted and misleading their clients about the portfolio manager's experience."

6. Citigroup: In August 2015, the SEC instituted a settled administrative proceeding charging that two affiliates of Citigroup defrauded investors in two hedge funds by claiming they were safe, low-risk and suitable for traditional bond investors.[11] Although the written materials provided to investors contained truthful disclosures, the SEC alleged that Citigroup Global Markets Inc. ("CGMI") and Citigroup Alternative Investments LLC ("CAI"), both registered investment advisers, failed to disclose the high risks of investing in the funds in verbal conversations with investors, and continued to accept investments even as the funds began to collapse amid the financial crisis. As noted by Andrew Ceresney, "Firms cannot insulate themselves from liability for their employees' misrepresentations by invoking the fine print contained in written disclosures."[12] CGMI and CAI were charged with certain violations of the Securities Act of 1933 and the Advisers Act that do not require scienter.

7. Ranieri: On March 8, 2013, the SEC filed and settled charges against Ranieri Partners LLC, Donald Phillips (a former senior executive at Ranieri Partners) and William Stephens (an external marketing consultant to Ranieri Partners).[13] The SEC alleged that Stephens acted as an unregistered broker in violation of Section 15(a) of the Securities Exchange Act in marketing and receiving placement fees for the sale of interests in two real estate funds organized and advised by Ranieri Partners. The settlement orders cite a number of factors as support for this allegation, including the fact that Stephens received "transaction-based compensation totaling approximately $2.4 million." The Ranieri case has two particular points of interest for private fund managers: First, unlike many other cases brought for failure to register as a broker-dealer, there were no allegations of fraud. Second, in addition to charging the consultant for failing to register as a broker-dealer, the SEC charged the private fund manager itself and a former senior executive at the manager.

D. Insider Trading

[10] *Id.*

[11] Press Release, Securities and Exchange Commission, Citigroup Affiliates to Pay $180 Million to Settle Hedge Fund Fraud Charges (Aug. 17, 2015), *available at* www.sec.gov/news/pressrelease/2015-168.html.

[12] *Id.*

[13] *In the Matter of Ranieri Partners LLC and Donald W. Phillips*, Securities Exchange Act Release No. 69091, Investment Advisers Act of 1940 Release No. 3563, Administrative Proceeding File No. 3-15234 (March 8, 2013); *In the Matter of William M. Stephens*, Securities Exchange Act Release No. 69090, Investment Company Act of 1940 Release No. 30417, Administrative Proceeding File No. 3-15233 (March 8, 2013).

1. Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder prohibit the purchase or sale of a security of any issuer, on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information.[14] Similarly, CFTC Rule 180.1 may prohibit a person from trading commodity interests on the basis of material nonpublic information in breach of a pre-existing duty (established by another law or rule, agreement, understanding or some other source), or trading on the basis of material nonpublic information that was obtained through fraud or deception.[15] While the CFTC has to date only brought one insider trading case, it has stated that it "will be guided, but not controlled, by the substantial body of judicial precedent applying the comparable language of SEC Rule 10b-5."

2. Galleon Cases: Since 2009, the SEC has charged 35 defendants trading in the securities of 15 companies generating illicit profits of more than $96 million.[16] A total of 34 defendants have settled the SEC's charges. The alleged illegal conduct involved Raj Rajaratnam and his New York-based hedge fund Galleon Management making cash payments in exchange for material nonpublic information. The case eventually implicated corporate executives, consultants, rating agency personnel, proprietary traders, hedge fund executives and public relations personnel.

3. Newman: Recently, the U.S. Court of Appeals for the Second Circuit reversed two high-profile insider trading convictions in *U.S. v. Newman*.[17] On Dec. 10, 2014, the Second Circuit held that to sustain insider trading charges against a tippee who trades on material nonpublic information, the government must prove that the tippee knew that the tipper disclosed the information in breach of a duty of trust and confidence in order to receive a personal benefit. The court further explained that the benefit must be objective and consequential. In doing so, the court criticized the government for "the doctrinal novelty of its recent insider trading prosecutions," which the court described as "increasingly targeted at remote tippees many levels removed from corporate insiders." Additionally, *Newman* rejects the notions that mere ephemeral benefits would suffice to constitute the breach, and that the tippee need not know that a personal benefit was the quid pro quo for the improper disclosure. Accordingly, the decision is expected to present new obstacles to criminal prosecutions and SEC enforcement actions alleging insider trading violations, particularly against remote tippees. We may already be seeing the effects of the decision in the Manhattan U.S. Attorney's Office dismissing criminal charges against a dozen people besides Todd Newman and co-defendant Anthony Chiasson — 10 of whom had already pled guilty to insider trading[18] — and in an in-house judge dismissing an SEC administrative proceeding against former Wells Fargo trader Joseph Ruggieri, after finding the Enforcement Division did not prove Ruggieri's alleged tipper received a significant personal benefit for his information.[19]

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[14] 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b–5.

[15] Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 76 Fed. Reg. 41398, 41399 (July 14, 2011).

[16] Securities and Exchange Commission, SEC Enforcement Actions: Insider Trading Cases, *available at* www.sec.gov/spotlight/insidertrading/cases.shtml.

[17] *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014).

[18] Ed Beeson, "SEC Retooling Insider Trading Tactics After Newman," *Law360* (Nov. 4, 2015), *available at* www.law360.com/articles/723289/sec-retooling-insider-trading-tactics-after-newman.

[19] *In the Matter of Gregory T. Bolan, Jr., and Joseph C. Ruggieri*, Initial Decision Release No. 877, Securities and Exchange Commission (Sept. 14, 2015).

4. Motazedi: On Dec. 2, 2015, the CFTC brought and settled an action against Arya Motazedi, a proprietary gasoline and energy trader at an unnamed public company in Chicago.[20] According to the CFTC, Motazedi had access to confidential, proprietary information concerning his employer's proprietary trading in energy commodities (e.g., timing, amounts and prices) and he used that knowledge: (i) to enter "opposite side" orders that matched with his employer's orders at least 34 times (causing the employer's account to buy energy futures at higher prices and sell at lower prices, profiting Motazedi and harming his employer), at least some of which were designed as "round trip" transactions (where both sides bought and sold with the other and neither party experienced a net change in its positions); and (ii) to "front run," on at least 12 occasions, his employer's orders (allowing Motazedi to benefit from any subsequent price movement caused by the subsequent execution of the employer's oil and gas futures orders). The CFTC noted that, of the two accounts that Motazedi controlled and utilized in these activities, he only owned one of them.

5. Riley: On March 4, 2015, the U.S. District Court for the Southern District of New York refused to reverse the insider trading conviction of former Foundry Networks Inc. executive David Riley.[21] Prosecutors alleged that Riley provided his friend Matthew Teeple, a former hedge fund analyst, with Foundry's financial data and advance notice of its 2008 acquisition by Brocade Communications Systems Inc. Citing the redefined personal benefit standard in *U.S. v. Newman*, Riley has argued to the Second Circuit that his conviction should be overturned because the jury instructions did not require jurors to find that he had received a personal benefit in exchange for providing information to Teeple. Judge Caproni of the Southern District of New York had held that the instructions were not improper because maintaining a friendship could be circumstantial evidence that the tipper and tippee had a "quid pro quo relationship." The court also pointed out that Riley had received "concrete" benefits in exchange for providing the inside information, namely investment advice, assistance with a side business, and help finding a new job.[22] Riley filed his appeal on Aug. 28, 2015.[23]

6. Policies and Procedures

   Rule 206(4)-7 of the Advisers Act provides that if you are an investment adviser registered or required to be registered under the Advisers Act, you must: (i) adopt and implement written policies and procedures reasonably designed to prevent violation, by you and your supervised persons, of the applicable federal securities laws; (ii) review, no less frequently than annually, the adequacy of such policies and procedures; and (iii) designate an individual (who is a supervised person) responsible for administering your policies and procedures.[24]

7. Importance of Documentation

   (a) SEC Document Requests: When the SEC staff conducts an examination of an adviser, they request information and documents from the adviser to assess the adviser's compliance with the applicable federal securities laws, including the Advisers Act and the Company Act. Ensuring documentation of compliance policies, procedures and the implementation of such

[20] *In the Matter of Arya Motazedi*, CFTC Docket No. 16-02 (Dec. 2, 2015). *See also* "The CFTC Brings (and Settles) Its First Insider-Trading Case: Implications for All Private Fund Managers," SRZ Alert (Dec. 15, 2015), *available at* www.srz.com/files/News/8ab2bc57-805e-4074-b7f6-9b16fec6c213/Presentation/NewsAttachment/86944d3b-244c-464f-82da-2195866c0973/121515_The_CFTC_Brings_and_Settles _Its_First_Insider_Trading_Case_Implications_for_All_Private_Fu.pdf.

[21] Jonathan Stempel, "U.S. Judge Upholds Insider Trading Conviction Despite Law Change," *Reuters* (March 4, 2015), *available at* www.reuters.com/article/us-usa-insidertrading-riley-idUSKBN0M02BE20150304.

[22] Docket Entry No. 252, *United States v. Riley*, No. 13-CR-339-1 (VEC) (S.D.N.Y. March 3, 2015).

[23] Docket Entry No. 44, *United States v. Riley*, No. 15-1541 (2d Cir. Aug. 28, 2015).

[24] 17 CFR 275.206(4)-7.

policies and procedures is, therefore, critical to preparing for an SEC examination. A document request list from the SEC staff may include, among other things:

(i) The firm's organizational charts;

(ii) Demographic and other data for advisory clients, including privately offered funds;

(iii) A trade blotter, i.e., a record of all trades placed for its clients/funds (including all trade errors, cancellations, re-bills and reallocations);

(iv) Information about the firm's compliance risks;

(v) The written policies and procedures that the firm has established and implemented;

(vi) Documents relating to the firm's compliance testing (e.g., the results of any compliance reviews, quality control analyses, surveillance, and/or forensic or transactional tests performed by the firm);

(vii) Information regarding actions taken as a result of compliance testing (e.g., any warnings to or disciplinary action of employees, changes in policies or procedures, redress to affected clients, or other measures);

(viii) Any restricted, watch, or grey lists that were in effect for the examination period;

(ix) Any threatened, pending and settled litigation or arbitration involving the firm or any "supervised person"; and

(x) Any client complaints.

E. Tag Along: From Examination to Enforcement

1. In general: There is a close connection between SEC examinations and enforcement actions as highlighted by Riewe in her February 2015 speech. Riewe noted there is close coordination and collaboration between the Enforcement Division and OCIE and that the Enforcement Division has always worked many cases referred by exam staff.[25] While she said she believed that not every exam deficiency warrants an enforcement response, she acknowledged it was important that exam staff have the ability to refer matters when in their judgment the conduct warrants enforcement action. Furthermore, the 2015 Agency Financial Report by the SEC provides that in fiscal year 2015, OCIE made more than 200 referrals, many of which resulted in enforcement investigations and/or actions.[26] The NFA tends to handle many of its enforcement actions internally and generally refers only the more serious allegations to the CFTC. NFA enforcement actions are generally related to conflicts of interest issues, late filings and failing to disclose or incorrectly disclosing conflicts, past performance, expenses and other related exposures. Trading-related issues are generally handled by the futures exchanges (who could also refer such cases to the CFTC).

2. Trend: While there have long been examinations that led to enforcement investigations, there is evidence indicating that the rate of referrals to the Enforcement Division has increased. OCIE's regional offices increased the number of cases referred to enforcement from 232 in fiscal year 2006

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[25] Riewe, *supra* note 6.

[26] Securities and Exchange Commission, Agency Financial Report, Fiscal Year 2015 (2015), *available at* www.sec.gov/about/secpar/secafr2015.pdf.

to 272 in fiscal year 2010, with a particularly large increase between fiscal year 2008 (198 cases) and fiscal year 2010.[27] Additionally, the SEC's Office of the Inspector General published a report in June 2001 stating that approximately 5 percent of investment adviser examinations result in a referral to the Enforcement Division, which can be contrasted with OCIE Director Andrew Bowden's recent statement that approximately 10 percent of investment adviser examinations result in a referral to enforcement.[28] Several Enforcement Division attorneys have also moved to OCIE, including the head of the investment adviser examination program in the New York Regional Office,[29] which covers a large segment of the private funds industry.

3. Notable Cases

(a) Transamerica: Transamerica Financial Advisors Inc. ("TFA"), a registered investment adviser and broker-dealer, allegedly failed to apply advisory fee discounts to certain retail clients in several of its advisory fee programs contrary to its disclosures to clients and its policies and procedures.[30] During the relevant period, TFA offered clients in these programs breakpoint discounts that reduced the total advisory fee as the clients' assets in the programs increase. In various Form ADV Part 2 filings and in account opening documents, TFA represented that clients may request that TFA aggregate the values of certain related accounts to achieve these discounts. In addition, TFA's policies and procedures required that clients receive the savings from breakpoint discounts. Despite these disclosures, from January 2009 to June 30, 2013, TFA allegedly failed, in certain instances, to apply the breakpoint discounts despite client requests for aggregation. The Commission's examination staff first alerted TFA to certain of these problems in early 2010, but TFA failed to take adequate remedial steps. As a result, TFA allegedly improperly calculated advisory fees and thereby overcharged certain client accounts.

(b) ZPR: On April 4, 2013, the SEC initiated cease-and-desist proceedings against ZPR Investment Management Inc. ("ZPR") following an SEC examination that showed ZPR's performance marketing to be misleading because ZPR claimed compliance with the Global Investment Performance Standards when that was not the case.[31]

(c) GMB: On April 20, 2012, the SEC initiated, and settled, cease-and-desist proceedings against GMB Capital Management LLC and GMB Capital Partners LLC (collectively "GMB") following an SEC examination of GMB that showed misrepresentations regarding performance, misrepresentations regarding fund strategy, and creation of false documents during the course of the examination to try to support the performance claims.[32]

(d) F-Squared: On Dec. 22, 2014, the SEC initiated, and settled, cease-and-desist proceedings against F-Squared Investments Inc. ("F-Squared") following an SEC examination that showed

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[27] Office of Inspector General, Securities and Exchange Commission, *OCIE Regional Offices' Referrals to Enforcement*, Report No. 493 (March 30, 2011), *available at* www.sec.gov/oig/reportspubs/493.pdf.

[28] *Compare* Office of Inspector General, Securities and Exchange Commission Audit No. 322, Compliance Inspection and Examination Referrals to Enforcement (June 28, 2001), *available at* www.sec.gov/about/oig/audit/322fin.pdf, *with* Yin Wilczek, "Only One in 10 SEC Exams Referred for Enforcement Action, Official Says," *Bloomberg BNA* (March 15, 2013).

[29] Press Release, Securities and Exchange Commission, Ken C. Joseph Named Head of Investment Adviser/Investment Company Examination Program in SEC's New York Regional Office (July 3, 2012), *available at* www.sec.gov/News/PressRelease/Detail/ PressRelease/1365171483018.

[30] *In the Matter of Transamerica Financial Advisors, Inc.*, Release No. 3808, Securities and Exchange Commission (April 3, 2014).

[31] *In the Matter of ZPR Investment Management, Inc. and Max E. Zavanelli*, Release No. IA 3574, Securities and Exchange Commission (April 4, 2013).

[32] *In the Matter of GMB Capital Management LLC, GMB Capital Partners LLC, Gabriel Bitran and Marco Bitran*, Release No. IA 3399, Securities and Exchange Commission (April 20, 2012).

back-tested returns were not properly identified as such.[33] F-Squared settled, agreeing to disgorgement and penalties of $35 million. The former CEO of F-Squared was charged with fraud under Sections 206 and 207 of the Advisers Act for his role in the misleading performance marketing.

(e) Alpha Titans: The SEC settled administrative and cease-and-desist proceedings against a registered adviser, Alpha Titans LLC, its principal and its general counsel for non-scienter fraud, custody rule and compliance charges.[34] The OCIE examination identified that the adviser and key individuals used assets of two affiliated private funds to pay for most of the firm's operating expenses, but it did not seek clear investor authorization to do so.[35] The funds' financial statements provided to investors also were misleading because they did not disclose the use of the funds' money by entities that its principal controlled.

(f) Other notable cases include the KKR case discussed above and *In the Matter of AlphaBridge Capital Management, LLC*,[36] in which the SEC settled administrative proceedings against a registered adviser, AlphaBridge Capital Management LLC ("Alphabridge"), and its two principals for their alleged fraudulent inflation of the prices of mortgage-backed securities held by certain private funds managed by AlphaBridge.

4. Whistleblowers

(a) KBR: On April 1, 2015, the SEC initiated, and settled, cease-and-desist proceedings against Houston-based global technology and engineering firm KBR Inc. for violating whistleblower protection Rule 21F-17 enacted under the Dodd-Frank Act.[37] KBR required witnesses in certain internal investigation interviews to sign confidentiality statements with language warning that they could face discipline and even be fired if they discussed the matters with outside parties without the prior approval of KBR's legal department. Since these investigations included allegations of possible securities law violations, the SEC found that these terms violated Rule 21F-17, which prohibits companies from taking any action to impede whistleblowers from reporting possible securities violations to the SEC. Increased protection for whistleblowers may lead to increased whistleblowing and related examinations or enforcement actions.

(b) Statistics: For each year that the whistleblower program has been in operation, the SEC has received an increasing number of whistleblower tips.[38] The number of whistleblower tips increased as follows: 334 in 2011; 3,001 in 2012; 3,238 in 2013; 3,620 in 2014; and 3,923 in 2015. The Office of the Whistleblower currently is tracking over 700 matters in which a whistleblower's tip has caused a Matter Under Inquiry or investigation to be opened or has been forwarded to Enforcement staff for review and consideration in connection with an ongoing investigation.

[33] *In the Matter of F-Squared Investments, Inc.*, Release No. IA 3988, Securities and Exchange Commission (Dec. 22, 2014).

[34] *In the Matter of Alpha Titans, LLC*, Release No. IA 4073, Securities and Exchange Commission (April 29, 2015).

[35] Agency Financial Report, Fiscal Year 2015, *supra* note 21.

[36] Release No. IA 4135, Securities and Exchange Commission (July 1, 2015).

[37] Press Release, Securities and Exchange Commission, SEC: Companies Cannot Stifle Whistleblowers in Confidentiality Agreements (Apr. 1, 2015), *available at* www.sec.gov/news/pressrelease/2015-54.html.

[38] Securities and Exchange Commission, 2015 Annual Report to Congress on the Dodd-Frank Whistleblower Program (2015), *available at* www.sec.gov/whistleblower/reportspubs/annual-reports/owb-annual-report-2015.pdf.

(c) Paradigm Capital: In 2015, the SEC's Whistleblower Program awarded eight whistleblowers with total awards of approximately $38 million,[39] including the following case: On April 28, 2015, the SEC announced a maximum whistleblower award payment of 30 percent of amounts collected in connection with *In the Matter of Paradigm Capital Management, Inc. and Candace King Weir*, File No 3-15930 (June 16, 2014), the Commission's first anti-retaliation case.[40] The proceedings involved a whistleblower who reported certain trading activity revealing that Candace King Weir ("Weir") caused her affiliated investment adviser Paradigm Capital Management Inc. ("Paradigm") to engage in principal transactions with C.L. King & Associates Inc., an affiliated broker-dealer owned by Weir, without providing effective disclosure to, or obtaining effective consent from, PCM Partners LP II, a hedge fund client advised by Paradigm.[41] The whistleblower received over $600,000 for providing information that led to the success of the SEC action.

(d) The CFTC's whistleblower program is relatively new and was established under the Dodd-Frank Act. The program was closely modeled after the SEC's program, although the CFTC has only paid out two whistleblower awards to date: a $240,000 payout in 2014 and $290,000 in September 2015. The CFTC did not provide any details regarding the resulting enforcement actions.

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[39] Press Release, Securities and Exchange Commission, SEC Announces Enforcement Results For FY 2015 (Oct. 22, 2015), *available at* www.sec.gov/news/pressrelease/2015-245.html.

[40] *See* Order Determining Award Claim, Exchange Act Rel No 74826, File No 2015-4 (April 28, 2015). The name of the case was included in the final order and accompanying press release because such information was already in the public domain in light of the earlier enforcement action in this matter

[41] *In the Matter of Paradigm Capital Management, Inc. and Candace King Weir*, Release No. IA 3857, Securities and Exchange Commission (June 16, 2014).

Tax Considerations for 2016

Schulte Roth & Zabel

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Noah's practice focuses on tax aspects of domestic and cross-border mergers and acquisitions, joint ventures, spinoffs, restructurings and workouts, and private equity fund formation issues. He has advised on complex transactions including the public acquisition of Safeway Inc. by Albertsons and a consortium led by Cerberus Capital Management LP; the sale of Orchard Brands Corporation to Bluestem Group Inc.; the acquisition by Cerberus of the automotive interiors business of Visteon Corporation; Tiptree Financial Inc.'s sale of subsidiary Philadelphia Financial Group Inc. to funds managed by the Tactical Opportunities Group of The Blackstone Group LP; and the sale by Cerberus, its affiliate The Traxis Group BV and Blue Bird Corporation of the outstanding capital stock of School Bus Holdings Inc., an indirect parent company of Blue Bird, to Hennessy Capital Acquisition Corp.

A member of the Tax Section of the New York State Bar Association, Noah is recognized as a leading lawyer by *The Legal 500 United States* and *New York Super Lawyers*, and he is also listed in *Private Funds Management*'s "30 Under 40: The 30 Most Influential Private Equity Lawyers Under the Age of 40." He is the co-author of "The Demise of CoCos and the Tax Consequences of Exchanging Convertible Debt" (Practicing Law Institute, Corporate Tax Practice Series).

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Philippe focuses his practice on the tax aspects of investment funds, mergers and acquisitions, international transactions, real estate transactions and financial instruments. He has advised on many major transactions involving sales or spinoffs of investment fund managers, including Senator Investment Group LP's sale of a minority stake to The Blackstone Group LP, Caxton Associates LP's sale of a minority interest to the Petershill II Fund affiliated with the Goldman Sachs Group Inc., and Credit Suisse's sale of Strategic Partners to Blackstone. Philippe advises on the tax aspects of securitizations, including his representation of affiliates of Fortress Investment Group LLC and affiliates of Highbridge Capital Management in the securitization of their leveraged facilities. He has also advised multiple alternative asset managers on the formation and structuring of funds, including Engineers Gate with the launch of a quant fund, Clearfield Capital with the launch of a hedge fund, Warlander Asset Management LP with the launch of a credit fund, and SG Capital Partners in the formation of a new fund; Gunnar Overstrom, formerly a partner at Maverick Capital Ltd., in the formation of Three Corner Global Investors LP; Junto Capital Management LP on the launch of Junto Capital Partners LP and Junto Offshore Fund Ltd.; Trian Fund Management LP on all aspects of launching new co-investment hedge funds; Sachem Head Capital Management LP with the launch of hedge funds and the establishment of long/short equity funds; and Capstone Investment Advisors LLC, JANA Partners, MKP Capital Management LLC and Scopia Fund Management LLC in their respective sales of a passive minority interest to Neuberger Berman Group-managed private equity fund Dyal Capital Partners. Philippe's recent real estate transactions include advising the Related/Oxford joint venture developing Hudson Yards on closing nearly $1.4 billion in equity investments and debt financing for the center's first tower, and advising Oxford in over $5 billion in financing of three office towers, a retail center and a residential building for the project; advising Arel Capital in a number of equity investments, including operating multi-family properties with significant retail components and ground-up development projects for modern condominium buildings in Manhattan and Brooklyn; and advising Perella Weinberg Partners on the acquisition of 50-percent ownership of interests in two hotels and the structuring of a REIT joint venture with Loews Corporation.

Chambers USA, *The Legal 500 United States*, *New York Super Lawyers* and *Tax Directors Handbook* have recognized Philippe as a leading lawyer. He is a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and also speaks at prominent industry events, including PLI's Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances 2015 conferences in New York and San Francisco. He also recently presented on topics including FATCA, customized solutions for investors, and management company structuring and operations.

Philippe earned his LL.M. in taxation and his J.D. from New York University School of Law. While pursuing his J.D., he was the recipient of a Gruss Fellowship. He obtained his B.S., *summa cum laude*, from Adelphi University.

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Nick principally advises investment management clients on the structuring of U.K. management companies, covering all relevant partnership and tax issues. He also advises more widely on U.K. and international tax issues relating to the taxation of private investment funds, and their U.K. investors and managers.

Listed in *The Legal 500 UK* as a leader in his field, Nick is a Chartered Tax Adviser and an associate of the Chartered Institute of Taxation, the leading body in the United Kingdom for taxation professionals dealing with all aspects of taxation. He also is a member of the Tax Committee of the Alternative Investment Management Association. He has written and spoken about U.K., EU and international tax issues for various publications and engagements, particularly in regards to how changes in tax codes and regulations affect hedge funds and their U.K. managers.

Nick completed his legal training at the College of Law and graduated from Corpus Christi College at the University of Oxford.

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David concentrates his practice on tax issues related to formation and operation of onshore and offshore investment funds and their investment managers; tax considerations related to employee and executive compensation, including deferred compensation programs; and partnership taxation.

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Recognized as a leader in his field by *Chambers USA*, *The Best Lawyers in America*, *The Legal 500 United States* and the *Tax Directors Handbook*, Shlomo is a member of the Tax Section of the New York State Bar Association. He regularly speaks at industry conferences and events, and his most recent presentations have addressed hedge fund and management company structures, funds in the energy space, tax considerations for private investment funds and FATCA. He is a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) as well as various SRZ alerts.

Shlomo earned his J.D. from Hofstra University School of Law.

Tax Considerations for 2016

I. Partnership Audits

A. On Nov. 2, 2015, the Bipartisan Budget Act was signed into law, effectively repealing TEFRA with respect to partnership tax returns filed for taxable years starting after 2017. Under the new regime, tax adjustments and collections are made at the partnership level rather than at the partner level, unless the partnership elects to pass adjustments through to its partners.

B. The new partnership audit procedures generally apply to all partnerships.

C. Partnerships with 100 or fewer partners can elect out of the procedures if each of the partners is an individual, a C corporation, a foreign entity that would be treated as a C corporation if it were domestic, an estate of a deceased partner or an S corporation.

1. In the case of a partner that is an S corporation, each S corporation shareholder is counted as a partner in determining whether the partnership has 100 or fewer partners.

2. Partnerships with partners that are other partnerships, trusts or pension trusts cannot elect out.

3. The election to opt out of the new rules must be made each year with a timely filed return for such taxable year, and notice thereof needs to be provided to the partners.

4. The election must include a disclosure of the name and taxpayer ID of each partner of the partnership, including each S corporation shareholder in the case of an S corporation partner.

D. Instead of appointing a tax matters partner, a partnership must designate a partnership representative who will have sole authority to act for and bind the partnership and all its partners in all audit and adjustment proceedings.

1. The partnership representative does not need to be a partner but must have a substantial presence in the United States.

2. No notice of an audit needs to be given to the partners. In addition, no appeals process exists if a partner disagrees with the result of an audit.

3. In the absence of a designation of a representative by the partnership, the Internal Revenue Service ("IRS") has the authority to select any person as the partnership representative for a partnership.

E. Following a partnership audit, the IRS will issue a Notice of Proposed Partnership Adjustment setting out the "imputed underpayment" required to be paid by the partnership.

1. An imputed underpayment is determined by netting all adjustments at the partnership level and multiplying by the highest tax rate for individuals or corporations for the reviewed year.

   (a) If an adjustment involves reallocation of an item to another partner, only the tax increase, not the net adjustment, enters into the calculation of the imputed underpayment.

   (b) Disregarding offsetting allocations in such situations has the effect of taxing the same income twice.

2. The partnership has 270 days to demonstrate to the IRS that its tax rate should be lower and the imputed underpayment should be reduced.

    (a) An imputed underpayment may be reduced to the extent that it is allocable to a partner that is a "tax-exempt entity" (e.g., the U.S. government, a tax-exempt U.S. organization, a foreign person or entity, etc.), a partner that is a C corporation (in the case of ordinary income) or an individual with capital gains or qualified dividends.

    (b) If any partner files an amended return for the reviewed year taking into account its allocable share of the adjustments and pays tax thereon, that payment can offset the partnership's imputed underpayment.

F. As an alternative to the partnership paying the imputed underpayment, the partnership may elect within 45 days after the date of a Notice of Final Partnership Adjustment to pass the adjustment through to its partners who were partners for the reviewed year.

1. The adjustment is passed through to the partners by issuing a statement to the reviewed year partners with their share of adjustments. The reviewed year partners are required to take the adjustments into account on their returns in the adjustment year (rather than amend their returns for the reviewed year).

2. An imputed underpayment is collected together with the partner's tax due for the adjustment year.

3. This special election removes partnership-level liability for the adjustments but makes the partnership responsible for identifying the reviewed year partners and appropriately allocating the adjustment among those partners.

4. The cost of making this election is that interest on an imputed underpayment is determined at the partner level at a rate that is 2 percent higher than the normal underpayment rate (i.e., short-term AFR + 5 percent).

G. A partnership can file an administrative adjustment request, i.e., an amended return, for any partnership taxable year.

1. Adjustments that result in underpayments will cause tax to be due at the partnership level or may be passed through to the partners under the election discussed above.

2. Adjustments that result in a refund must be passed through to the partners as additional deductions in the current year.

3. Any underpayment is paid by the partnership when the administrative adjustment request is filed.

H. The new partnership audit rules are effective for returns filed for taxable years starting after Dec. 31, 2017, although partnerships may elect to apply the new rules to any returns filed for taxable years beginning after Nov. 2, 2015.

II. Inversions

A. The IRS and Department of the Treasury announced in Notice 2015-79 that they will issue regulations to address transactions that are structured to avoid the purposes of Section 7874, as well as certain post-inversion tax avoidance transactions. They also announced certain corrections and clarifications that Treasury and the IRS intend to make with respect to certain rules announced in Notice 2014-52.

1. Notice 2014-52: Notice 2015-79 builds on Notice 2014-52, issued in November 2014, which effectively prevents certain inversion transactions by causing them to fail the threshold tests in Section 7874 of the Internal Revenue Code (the "Code") for what constitutes an inversion as well as diminishing the effectiveness of certain post-inversion tax-minimization strategies historically employed by inverted companies, particularly those that allow inverted companies to access cash "trapped" in offshore entities.

   (a) Rules That Impact Whether a Transaction Constitutes an Inversion

      (i) Regulations under Sections 7874 and 367 expanded with regard to pre-inversion "skinny-down" distributions

      (ii) Regulations under Section 7874 targeting so-called "cash-box" inversions

      (iii) Regulations under Section 7874 targeting "spinversions"

   (b) Rules Limiting Certain Post-Inversion Tax Strategies

      (i) Regulations under Section 956 expanded to cover "hopscotch" transactions

      (ii) Regulations under Section 7701(l) expanded to limit post-inversion de-controlling of controlled foreign corporations ("CFCs")

      (iii) Regulations under Section 304 limiting transactions designed to remove untaxed foreign earnings and profits while bypassing tax in the United States

2. Notice 2015-79: Similar to Notice 2014-52, Notice 2015-79 proposes rules that will make it more difficult for companies to successfully invert, as well as curtailing certain tax benefits for inverted companies.

   (a) Rules That Impact Whether a Transaction Constitutes an Inversion

      (i) Limit ability to use a "third country" as the new parent in an inversion transaction

      (ii) Disregard all assets (active or passive) transferred to the foreign party to an inversion with a principal purpose of avoiding the purposes of Section 7874 (i.e., inflating the value of the foreign company to avoid the shareholder thresholds for an inversion)

      (iii) Strengthen "substantial business activities" exception by requiring the parent to be subject to tax as a resident in its country of organization

   (b) Rules Limiting Certain Post-Inversion Tax Strategies

      (i) Expand the scope of "inversion gain" for which current U.S. tax must be paid to include certain indirect income inclusions, such as those from CFCs of the inverted U.S. companies

      (ii) Require that built-in gain in CFC stock be recognized in certain cases, without regard to the amount of deferred earnings of the CFC

(c) Favorable Changes

(i) Provide that assets used in an active insurance business within the meaning of the PFIC rules as well as certain banking or insurance assets held by domestic corporations are not treated as passive assets for purposes of Notice 2014-52 "cash box" rule.

(ii) Added de minimis exception for "skinny down" transactions of a U.S. company acquired by a foreign company for all or mostly cash.

(d) Effective Date: The rules are generally applicable to transactions completed on or after Nov. 19, 2015, though taxpayers may elect the application of the favorable rules above for transactions completed prior to such date. The rules that curtail certain post-inversion tax strategies also apply prospectively, but only to companies which inverted on or after Sept. 22, 2014 (the date of the prior inversion Notice).

(e) The Notice indicates that Treasury and the IRS expect to issue additional guidance to further limit inversions and post-inversion tax planning, particularly with respect to strategies that shift tax on U.S. operations to lower-tax jurisdictions through intercompany debt or otherwise (i.e., "earnings stripping").

III. Proposed Regulations Under Section 707 Relating to Management Fee Waivers

A. On July 22, 2015, Treasury and the IRS released proposed regulations (the "Proposed Regulations") under Section 707 of the Code that are intended to provide guidance on when a compensation arrangement between a partnership and a partner will be treated as a disguised payment for services.

1. The Proposed Regulations are generally intended to address so-called "management fee waivers," in which management companies waive their right to receive a portion of their management fees in exchange for a profits interest in the fund.

2. Although hedge funds have generally not adopted fee waiver programs, such programs are not uncommon among private equity funds. The specific terms of such programs, however, vary widely from fund to fund. Certain funds permit the sponsor to make periodic waiver elections, while others have adopted more of a "baked in" approach, with the waiver amount set at the beginning of the fund. Still others simply increase the economics of the general partner in the waterfall at the inception of the fund and have no concept of a fee waiver in the document.

3. Although the Proposed Regulations apply more broadly to any arrangement between a partnership and partner providing services, the Proposed Regulations were not intended to target standard incentive allocation or carried interest provisions common to hedge funds and private equity funds.

B. An allocation treated under Section 707 as a disguised payment for services will be treated as a payment for services for all purposes of the Code. In particular, the payment will be taxed as ordinary income, be subject to the deferred compensation regimes of Code Sections 409A and 457A (if applicable), and be subject to the applicable capitalization and deduction rules for the partnership.

C. In determining whether an allocation and distribution to a service provider constitute a disguised payment for services, the Proposed Regulations apply a facts and circumstances analysis and offer six non-exclusive factors. The most important factor is whether the arrangement has significant entrepreneurial risk ("SER").

1. An arrangement that lacks SER is treated as a disguised payment for services, whereas an arrangement that has SER will generally not constitute a disguised payment for services. The Proposed Regulations list facts and circumstances that create a presumption that an arrangement does not have SER:

   (a) Capped allocations of income if the cap is reasonably expected to apply in most years;

   (b) An allocation for one or more years under which the service provider's share of income is reasonably certain;

   (c) An allocation of gross income;

   (d) An allocation that is predominantly fixed in amount, is reasonably determinable under all facts and circumstances, or is designed to assure that sufficient net profits are highly likely to be available to make the allocation to the service provider;

   (e) Waiver by a service provider of its right to receive payments for the future performance of services in a manner that is non-binding or fails to timely notify the partnership and its partners of the waiver and its terms.

   Examples in the Proposed Regulations provide some guidance as to whether certain arrangements have SER. The examples make clear that Treasury is skeptical of arrangements that are based on profits over a period of time that is less than the life of the fund (e.g., 12 months) and for which the general partner has control over when profits are realized. However, the examples also indicate that a 12-month period is not a problem per se, particularly where the fund uses mark-to-market accounting (in the example, the fund makes a Section 475 election), and thus does not have control over whether profits are available to support the allocation.

2. In addition to the lack of SER, the Proposed Regulations list other factors that suggest a disguised payment for services:

   (a) The service provider holds a transitory partnership interest or a partnership interest for only a short duration.

   (b) The service provider receives an allocation and distribution in a timeframe comparable to the timeframe that a non-partner service provider would typically receive payment for services.

   (c) The service provider becomes a partner primarily to obtain tax benefits that would not otherwise have been available if the services were rendered to the partnership in a third-party capacity.

   (d) The value of the service provider's interest in general and continuing partnership profits is small in relation to the allocation and distribution it receives.

   (e) The arrangement provides for different allocations or distributions with respect to different services received, the services are provided either by one person or by related persons, and the terms of the differing allocation or distributions are subject to levels of entrepreneurial risk that vary significantly.

D. The regulations would apply to all arrangements entered into or modified after the date that final regulations are published in the *Federal Register*.

1. If an existing arrangement permits a service provider to waive all or a portion of its fee for any period subsequent to the date the arrangement is created, then the arrangement is considered modified for purposes of the effective date on the date that the fee is waived.

2. Notwithstanding the fact that final regulations may not apply to an existing fee waiver plan, Treasury has indicated that it may still challenge plans lacking significant entrepreneurial risk using the existing statute, as it believes its position is consistent with the legislative history.

E. The Proposed Regulations also announce the intent of Treasury and the IRS to modify Rev. Proc. 93-27, which provides a "safe harbor" that the receipt of a profits interest for services provided to a partnership is generally a non-taxable event (i.e., valued based on liquidation value, which is zero for a true profits interest).

1. The modification to Rev. Proc. 93-27 would remove from this safe harbor a profits interest issued in connection with a management fee waiver program. This modification is very significant because it removes safe-harbor protection even if the fee waiver avoids recharacterization as a disguised fee under the new regulations.

2. Treasury also states that its interpretation of the safe harbor is that it does not apply to transactions in which a service provider (e.g., the management company of the fund) waives the fee and a different entity (e.g., the general partner of the fund) receives the profits interest because: (i) the transaction does not satisfy the requirement that receipt of a profits interest be for the provision of services in a partner capacity; and (ii) the service provider would have effectively disposed of the interest within two years of receipt.

F. Treasury states that the emphasis on SER requires changing an existing provision regarding guaranteed payments under Treas. Reg. 1.707-1.

1. In its current form, Example 2 of Treas. Reg. 1.707-1(c) provides that if a partner is entitled to the greater of a fixed amount or a percentage of partnership profits, the fixed amount is not treated as a guaranteed payment to the extent the amount actually allocated based on such percentage exceeds the fixed amount.

2. The Proposed Regulations modify the example to provide that the entire fixed amount is treated as a guaranteed payment, regardless of partnership profits.

IV. Dividend Equivalent Payments: Section 871(m)

A. Introduction

1. In 2010, Section 871(m) of the Code was enacted to treat as U.S. source dividends for U.S. withholding tax purposes:

(a) "Dividend equivalent payments" on "specified notional principal contracts" based on a four-factor statutory definition; and

(b) Substitute dividend payments on securities lending or sale-repurchase transactions.

2. On Sept. 17, 2015, Treasury issued final and temporary regulations (the "Final Regulations" and "Temporary Regulations," respectively, and together the "2015 Regulations") implementing Section 871(m) of the Code.

B. Current Law Overview

1. Under current law, a notional principal contract ("NPC") (generally, an equity swap) is a "Specified NPC" subject to withholding under Section 871(m) if the NPC provides for one or more amounts that may be contingent upon, or determined by reference to, U.S.-source dividends and at least one of the following four factors are present:

(a) In connection with entering into the NPC, a long party to the NPC transfers the underlying security to a short party to the NPC (known as "crossing in");

(b) In connection with the termination of the NPC, a short party to the NPC transfers the underlying security to a long party to the NPC (known as "crossing out");

(c) The underlying security is not readily tradable on an established securities market; or

(d) The underlying security is posted as collateral by a short party to the NPC with a long party to the NPC.

2. The current rules apply to transactions entered into on or before Dec. 31, 2016. Transactions entered into on or after Jan. 1, 2017 will be subject to the 2015 Regulations as described below.

C. The 2015 Regulations

1. Transactions That Can Give Rise to "Dividend Equivalent Payments" ("Section 871(m) Transactions")

(a) A "dividend equivalent" is any of:

(i) A substitute dividend that references a U.S. source dividend made pursuant to a securities lending or sale-repurchase transaction;

(ii) A payment that references a U.S. source dividend made pursuant to a specified notional principal contract (a "specified NPC");

(iii) A payment that references a U.S. source dividend made pursuant to a specified equity-linked instrument (a "specified ELI"); or

(iv) Another substantially similar payment.

(b) An NPC for purposes of Section 871(m) generally means an equity swap.

(c) An equity-linked instrument ("ELI") for purposes of Section 871(m) generally means any financial transaction that references the value of one or more underlying equity securities, potentially including: forward contracts, futures contracts, swaps, options, convertible preferred stock, convertible debt instruments and debt instruments linked to underlying equity securities.

The "portfolio interest" exception to interest withholding will not apply to any dividend equivalent payment under a debt instrument.

2. Miscellaneous Issues Regarding Dividend Equivalent Amounts

   (a) Any gross amount that references the payment of a U.S. source dividend, whether actual or estimated, explicit or implicit, is treated as a dividend equivalent to the extent of the amount determined under the 2015 Regulations.

      For example, the Final Regulations treat a price return swap as a transaction that provides for the payment of a dividend equivalent because the anticipated dividend payments are presumed to be taken into account in determining the other terms of the NPC.

   (b) A dividend equivalent with respect to a Section 871(m) transaction is reduced by the amount of any deemed dividend arising from adjustments of convertible debt instruments and other ELIs under Section 305 of the Code, such as a change to the conversion ratio or conversion price of a convertible debt instrument. Such a deemed dividend may still be subject to withholding under other Code sections.

   (c) A payment referencing a distribution on an underlying security is not a dividend equivalent subject to Section 871(m) to the extent that the distribution would not be subject to U.S. withholding if the long party owned the underlying security directly.

3. The “Delta” and “Substantial Equivalence” Tests

   (a) An NPC or an ELI is a specified NPC or specified ELI subject to Section 871(m) if the instrument has a “delta” of 0.8 or greater in the case of a “simple contract,” or if a “substantial equivalence” test is satisfied in the case of a “complex contract,” which is in each case determined at the time of the instrument’s “issuance.”

      (i) A “simple contract” is a contract that: (i) references a fixed number of shares (that is known when the contract is issued) of one or more issuers to determine the payments under the contract; and (ii) has a single maturity or exercise date on which all amounts are required to be calculated.

      (ii) A contract can still be a simple contract if it has a range of potential exercise dates (such as an option) as long as amounts due under the contract are determined by reference to a single, fixed number of shares on the exercise date.

      (iii) A “complex contract” is any contract that is not a simple contract, e.g., if the number of shares of stock referenced by the contract is not fixed, but rather varies based on the payoff amount, time of payout or some other factor.

   (b) The “delta” of a simple contract is generally a measure of how sensitive the fair market value of an instrument is to changes in the fair market value of the underlying security, generally ranging from 1 (completely dependent on the value of the underlying security) to 0 (completely independent of the value of the underlying security).

   (c) For a complex contract, the “substantial equivalence” generally measures the correlation between the value of the contract and the value of the shares used to hedge the contract at various testing prices. If this correlation is greater than the equivalent calculations performed for a simple contract specified ELI or a specified NPC, then the complex contract is a specified ELI or a specified NPC, as applicable. Treasury has invited comments to the “substantial equivalence” test.

4. Determining Delta/Substantial Equivalence

   (a) The determination of whether an instrument is a specified ELI or a specified NPC is made only on the date the instrument is "issued."

   An instrument is treated as issued when it is issued, entered into, purchased or otherwise acquired at its inception or original issuance, including an issuance that results from a deemed exchange pursuant to Section 1001 of the Code.

   (b) If one of the parties to a transaction subject to Section 871(m) is a broker or dealer, that party is required to determine whether a potential Section 871(m) transaction is a Section 871(m) transaction and report the timing and amount of any dividend equivalent to the other party.

   (c) If neither or both parties are dealers or brokers, then the short party must make such determination and provide such reporting.

5. Baskets, Indices and Miscellaneous Situations

   (a) Baskets: If a short party issues a contract that references a basket of 10 or more underlying securities and hedges the contract with an exchange-traded security that references substantially the same underlying securities, then the short party may use the hedge security to determine the delta of the contract it is issuing.

   (b) Combined Transactions: If a long party (or a related person) enters into two or more transactions that reference the same underlying security and the transactions were entered into in connection with each other, then the transactions are combined and treated as a single transaction for purposes of Section 871(m).

      (i) If a broker does not have actual knowledge that multiple transactions were entered into in connection with each other, the broker may generally presume the transactions were not entered into in connection with each other if either: (i) the transactions were entered into two or more business days apart; or (ii) the transactions are held in different accounts.

      (ii) The Final Regulations do not provide for the netting of a taxpayer's long and short positions, though the preamble to the Final Regulations leaves open the possibility of more expansive rules in the future.

   (c) Transactions Referenced to Partnership Interests: Section 871(m) only applies to payments on an NPC or ELI that references a payment on a partnership interest when the partnership: (i) is a trader or dealer in securities; (ii) holds significant investments in securities; or (iii) holds an interest in a lower-tier partnership described in (i) or (ii).

   A partnership is considered to hold significant investments in securities if either 25 percent or more of the value of the partnership's assets consist of underlying securities or potential Section 871(m) transactions, or the value of the underlying securities or potential Section 871(m) transactions equals or exceeds $25 million. In this case, dividend equivalent payments are determined by looking through to such partnership's underlying assets.

   (d) Indices: Transactions that reference a qualified index are generally excepted from Section 871(m). The qualified index exception is designed to provide a safe harbor for widely used passive indices that reference a diversified portfolio of long positions, and is not intended to apply to any index that: (i) is customized or reflects a trading strategy; (ii) is not generally available; or (iii) targets dividends.

(e) Anti-Abuse Rule: The IRS Commissioner may treat any payment on a transaction as a dividend equivalent if the taxpayer entered into or acquired the transaction with a principal purpose of avoiding Section 871(m). The IRS may also avail itself of general common law and statutory rules in order to challenge transactions that are designed to avoid the application of Section 871(m).

V. Deferred Fees

A. Who Is Subject to Section 409A?

Service providers who are subject to U.S. income tax and who account for gross income from the performance of services using the *cash method of tax accounting* are generally subject to Section 409A.

1. Employees described above are subject to Section 409A.

2. Cash method providers of investment management services (e.g., investment management firms or consultants who provide investment management services) are subject to Section 409A, even if they would otherwise satisfy the requirements to meet an independent contractor exemption from Section 409A.

3. Partners are generally not subject to Section 409A with respect to partner compensation arrangements, other than certain "guaranteed payments."

B. Who Is Subject to Section 457A?

Service providers who are subject to U.S. income tax and who account for gross income from the performance of services <u>*to a nonqualified entity*</u> using <u>*any*</u> *method of tax accounting* are generally subject to Section 457A.

1. Employees described above are subject to Section 457A.

2. Providers of investment management services (e.g., investment management firms or consultants who provide investment management services) are subject to Section 457A, even if they would otherwise satisfy the requirements to meet an independent contractor exemption from Section 409A.

3. Partners are generally not subject to Section 457A with respect to partner compensation arrangements, other than certain "guaranteed payments."

C. Nonqualified Entity

1. Any foreign corporation unless substantially all of its income is:

(a) Effectively connected with the conduct of a trade or business in the United States and is not otherwise exempt from U.S. federal income tax; or

(b) Subject to a comprehensive foreign income tax.

This generally means that the corporation is eligible for the benefits of a comprehensive income tax treaty with the United States, where the income is taxed and the corporation is not treated materially more favorably than other corporate taxpayers

2. Any partnership where more than 20 percent of its income is allocated to:

   (a) Foreign persons with respect to whom such income is neither subject to a comprehensive foreign income tax nor "effectively connected income"; and

   (b) Tax-exempt U.S. entities, unless the income is "unrelated business taxable income" that is taxable to such entities.

D. What Is a Deferral of Compensation Under Section 409A?

1. Compensation will be considered deferred if the service provider has a *legally binding right* to the compensation in one taxable year and payment either *is* or *may* be made after the later of:

   (a) The 15th day of the third month following the *service provider's* first taxable year in which there is no longer a substantial risk of forfeiture attached to the right to the payment; or

   (b) The 15th day of the third month following the *service recipient's* first taxable year in which there is no longer a substantial risk of forfeiture attached to the right to the payment.

2. A *legally binding right* does not exist if the service recipient can unilaterally reduce or eliminate the compensation, using a facts and circumstances test.

3. A s*ubstantial risk of forfeiture* exists if the service provider's rights to the compensation are conditioned on:

   (a) The future performance of substantial services by an individual; or

   (b) The occurrence of a condition related to the purposes of the compensation, where forfeiture is a substantial possibility.

E. What Is a Deferral of Compensation Under Section 457A?

1. Compensation <u>from a *nonqualified entity*</u> will be considered deferred if the service provider has a *legally binding right* to the compensation in one taxable year and payment <u>is</u> made after <u>12 months following the</u> *service recipient's* first taxable year in which there is no longer a substantial risk of forfeiture attached to the right to the payment.

2. A *legally binding right* does not exist if the service recipient can unilaterally reduce or eliminate the compensation, using a facts and circumstances test.

3. A s*ubstantial risk of forfeiture* ***<u>only</u>*** exists if the person's rights to compensation are conditioned on the future performance of substantial services by an individual.

F. What Are the Consequences of a Section 409A Violation?

1. All compensation deferred under the plan for the current year and all previous years is included in current income, to the extent not subject to a substantial risk of forfeiture and not previously included in income.

2. *Interest at the underpayment rate + 1 percent* is charged on the underpayments of tax on such amounts had such amounts been included in income for the year deferred.

3. An *additional tax equal to 20 percent* of the amount included in income under 1 above is added to the current year's tax.

G. What Are the Consequences of Having Compensation Taxed Under Section 457A?

If the amount is not paid by the end of the service recipient's tax year following the year in which the compensation is no longer subject to a substantial risk of forfeiture, ***either***:

1. Amounts are included in income for the year in which the services are rendered (*i.e.,* ***taxed as accrued***); or

2. If the amount is not determinable, then:

   (a) Such amount is included in current income for the year in which such amount becomes determinable;

   (b) Interest at the underpayment rate + 1 percent is charged on the underpayments of tax on such amount had such amount been included in income for the initial year in which the services generating such compensation were rendered; and

   (c) An *additional tax equal to 20 percent* of the amount included in income under (a) above is added to the current year's tax.

H. Common Compensation Caught Up in the Section 457A Net

1. "Traditional" hedge fund deferred compensation

2. Incentive fees from "side-pocket" investments

3. Compensation based on a multi-year performance period

4. Employee deferred bonuses from certain portfolio companies or "nonqualified" management companies

I. Taxation of Maturing Deferrals

1. Taxable no later than 2017, whether or not paid by Dec. 31, 2017

2. Side-pocket or non-fund investment value still must be paid

   (a) Can pay in kind

J. Tax Planning by Manager for Maturing Deferrals

1. Investing in offshore fund in 2017 with a QEF election: deferred fee expense reduces QEF income inclusion for 2017

2. Charitable contributions (limits on what people can get a deduction for)

3. If the deferral arrangement is not "back-to-back" with the management company's partners, the management company can pay out other expenses (e.g., employee bonuses) by Dec. 31, 2017

4. Election to go on accrual method

   (a) Consider whether to elect for 2016 or 2017.

   (b) If back-to-back deferral arrangement, partner taxation on distributions would not match up with the accrual method 4-year spread.

      (i) The management company's partners are taxed on the accrued amount ratably over four years, beginning with the year of accounting method change. Cash must be distributed, however, based on the deferral plan in effect.

      (ii) If the partners elect to "re-defer" the receipt of their share of the deferred fees from the management company, such election must push back their distribution dates by a minimum of five years and must be made a year in advance of the distribution date. Such action would generally leave sizeable assets sitting in the management company for several years.

K. Asset Allocator Diligence

1. What is the manager looking to do with the deferred fees? Note that potentially half of the amount or more will be paid to the government in taxes.

2. What percentage of the fund do the fees represent/how will the manager liquidate the portfolio in order to pay the deferred fees?

VI. United Kingdom: 'Disguised Investment Management Fees' and 'Performance-Related Returns'

Over the past 12 months, the United Kingdom has introduced what is in effect a comprehensive new regime for the taxation of sums received by investment managers for the provision of investment management services in the United Kingdom. The new regime is to be introduced in three stages: (i) new rules on taxation of "disguised investment management fees" that were effective April 6, 2015 (the "DIMF" rules); (ii) new rules on the taxation of carried interest (which are referred to as "performance-related returns" or "performance-linked rewards") that were effective Oct. 22, 2015; and (iii) new rules on "income-based carried interest" that will be effective April 6, 2016.

A. Disguised Investment Management Fees

1. Under the DIMF rules effective April 6, 2015, all sums arising to an individual for the provision of investment management services that are "untaxed" (the sums arising could be by way of profit allocation, loan, advance, dividend or in any other form) are, subject to two exceptions set out below, treated as the profits of a trade carried on by that individual. The individual is likely to be subject to tax on the profits of this deemed trade at rates of 45 percent income tax and 2 percent national insurance contributions (NIC). Sums arising to the individual manager are "untaxed" unless the manager is already chargeable to income tax and NIC on the sums as employment income or trading income.

2. The exceptions to the taxation of a sum arising to a manager under the DIMF rules are: (i) if the sum arising is an arm's-length return on an investment made by the manager in the fund (the investment being of the same kind of investments in the fund made by external investors); or (ii) if the sum

arising is "carried interest." A sum will be "carried interest" if it is a "profit-related return" — that is, a sum that arises only if the fund has profits for a period and which is variable, to a substantial extent, by reference to those profits, provided that the returns to external investors are also determined by reference to the same profits. However, a sum will not be "carried interest" if, at the time that the manager became party to the arrangements or began to perform investment management services, there was "no significant risk" that the sum would not arise.

3. Where a sum is treated as profits of a deemed trade under the DIMF rules, the deemed trade is treated as carried on inside or outside the United Kingdom to the extent that the manager performs the investment management services from which the sum is treated as arising inside or outside the United Kingdom. For a U.K. tax resident manager, this will mean that all of the sums arising (all of the profits of the deemed trade) are subject to U.K. income tax and NIC. However, for a non-U.K. tax resident manager — e.g., a U.S.-based manager — who spends some amount of time in the United Kingdom, there remains the possibility that the manager may be subject to tax under the DIMF rules on sums arising to him to the extent that those sums are considered to arise from investment management services that he performs in the United Kingdom. In most cases, however, it is considered that such a manager may be able to avoid taxation under the business profits article an applicable double tax treaty between the United Kingdom and the manager's jurisdiction of residence, which would generally provide that the manager would be subject to U.K. taxation only to the extent that he had a "permanent establishment" in the United Kingdom. If the manager's time spent in the United Kingdom is sufficiently limited to avoid the creation of a "permanent establishment," sums arising to that manager for the provision of investment management services in the United Kingdom should not be liable to taxation under the DIMF rules.

B. Carried Interest or 'Performance-Related Returns'

1. As described above, sums arising to a manager that are "carried interest" are excluded from taxation as profits of a deemed trade under the DIMF rules. However, with effect from Oct. 22, 2015, the United Kingdom introduced a new stand-alone capital gains regime for the taxation of carried interest.

2. Under this new regime, all amounts of carried interest — as defined in the DIMF rules — arising to a manager on or after Oct. 22, 2015 are subject to a capital gains tax ("CGT") charge of 28 percent.

3. If the manager is also subject to other tax charges on the carried interest (e.g., if the carried interest is wholly or partly comprised of interest or dividends, on which the manager may be chargeable to income tax, or an allocation of realized capital gains, on which the manager may be separately chargeable to CGT), the manager may make a claim for credit for those other taxes against the CGT charge in order to avoid potential double taxation.

4. One important feature of the new carried interest CGT charge is that where the investment management services that give rise to the carried interest are performed in the United Kingdom, a non-U.K. domiciled manager will not be able to use the remittance basis of taxation to defer the CGT charge on carried interest. This is a significant difference from the position that prevailed prior to the introduction of this new carried interest CGT charge, where the remittance basis was available to a non-U.K. domiciled manager to the extent that the carried interest comprised an allocation of capital gains arising from the realization of non-U.K. situs assets or non-U.K. source income.

C. Income-Based Carried Interest

1. Further draft legislation issued alongside Finance Bill 2016 sets out additional changes to the taxation of carried interest arising on or after April 6, 2016.

2. Under these new rules, sums arising to an individual from the performance of investment management services will qualify as carried interest (and so be excluded from the charge to income tax and NIC under the DIMF rules, but be subject to CGT under the new carried interest CGT charge) only if the fund has an average value-weighted holding period for its investments of at least three years. Where the average value-weighted holding period of the fund's investments is between three and four years, partial CGT treatment will be available, but full CGT treatment (i.e., full exclusion from income taxation under the DIMF rules) will be available only if the average value-weighted holding period of the fund's investments is at least four years. There are complex rules setting out how the average value-weighted holding period of fund's investments is to be calculated.

3. The U.K. government has been clear, in putting forward its proposals, that the income-based carried interest rules are intended not to affect carried interest in private equity funds, where the average investment-holding period is more than four years, but are intended to stop funds with a shorter-term "trading strategy" (such as hedge funds) from giving managers rewards that benefit from CGT treatment.

Permanent Capital and Other Registered Funds: Access to New Capital Sources

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PRIVATE INVESTMENT FUNDS SEMINAR

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Ken represents investment advisers, broker-dealers and banks in connection with the organization and operation of investment funds, including mutual funds, hedge funds, closed-end investment companies, business development companies and bank collective investment funds. He has worked with clients in developing novel hybrid fund products, including registered hedge funds, registered funds of hedge funds and liquid alternatives products. Ken also advises clients on a broad range of securities regulatory and compliance matters, and represents mutual fund independent directors.

Prior to entering private practice, Ken served as special counsel in the SEC's Division of Investment Management in Washington, D.C. He is a member of the American Bar Association's Committee on the Federal Regulation of Securities and a member of its Subcommittee on Investment Companies and Investment Advisers, and has been a member of the New York City Bar Association's Committee on Investment Management Regulation. Ken is a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press), and he has addressed issues for hedge fund managers acting as advisers and sub-advisers to registered funds and has spoken at industry conferences on various matters, including registered alternative investment funds.

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Dan concentrates his practice on the design, structure and regulation of alternative investment products, including hedge funds, hybrid funds and private equity funds. He regularly advises funds that invest in distressed debt, asset-backed securities and bank loans. Dan also provides day-to-day regulatory, operational, merger and acquisition, and restructuring advice to his fund clients, and he advises funds regarding the receipt or allocation of seed capital. As part of his compliance practice, he advises clients on the Treasury Forms (TIC Forms) and Bureau of Economic Affairs Forms (BEA Forms).

Dan has been recognized in *The Legal 500 United States* in the Investment Fund Formation and Management and Private Equity Funds categories. A sought-after speaker, he recently presented on topics including the structuring and management of funds, compliance and regulatory issues, and ERISA's impact on private equity and hedge funds. He is a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press), and he has served as a guest lecturer at the New York University School of Continuing and Professional Studies, where he taught "Introduction to Hedge Funds." He also serves on the University of Michigan Honors Alumni Council.

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John primarily represents private equity firms and other financial sector participants in a wide range of capital markets and securities law matters. He regularly assists clients in connection with the establishment and operation of business development companies, registered closed-end funds and other similar public and private vehicles that comply with complex regulatory structures, including the Investment Company Act of 1940, the Investment Advisers Act of 1940 and the Dodd-Frank Act. With more than a decade of experience, John has been involved with more than 100 debt and equity offerings, including over 20 IPOs, reflecting an aggregate of over $10 billion in total proceeds. His work in securities law and mergers and acquisitions includes providing guidance to many New York Stock Exchange and Nasdaq-listed companies in connection with ongoing corporate governance and U.S. Securities and Exchange Commission reporting and compliance matters. John also routinely handles issues involving tender offers, proxy solicitations, going-private transactions and beneficial ownership reporting obligations.

John is a recipient of the SEC Capital Markets Award, and he was named a *Washington, DC Super Lawyers* "Rising Star." He serves as an adjunct professor at The George Washington University Law School and is the former chair of the Corporate Finance Committee of the Corporation, Finance and Securities Law Section of the District of Columbia Bar. He has spoken and written on topics that include SEC regulations and capital-raising, executive compensation disclosure and implications of Rule 144 revisions, and SPACs and M&A issues.

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Permanent Capital and Other Registered Funds: Access to New Capital Sources

I. Background

A. Industry Trends and Developments

1. In recent years, mutual fund advisers and financial intermediaries (including broker-dealers, banks, financial advisers and insurance companies) have begun to add alternative investments to their product menus and recommended client portfolio allocations.

2. Some firms have built their own infrastructures to deliver alternative investment products. Others have partnered with managers of private investment funds, formed joint ventures to offer these products or acquired private fund managers.

3. One reason for these developments is the increased focus of traditional advisory firms and financial intermediaries on high-net-worth investors and the “mass affluent” market. In addition, to reduce volatility and provide a source of non-correlated returns, a growing number of financial intermediaries are recommending allocation of clients’ assets to alternative asset classes and alternative strategies that seek “absolute returns.”

4. Alternative investment products offer a way for traditional asset managers and fund distributors to: enhance revenues (from performance-based compensation structures), diversify sources of revenues, offer new opportunities to portfolio managers and retain key talent, and satisfy the growing demand for alternative investment strategies.

5. A growing number of private fund managers are seeking to grow their assets under management by accessing retail investors and distribution channels (including the 401K market) and are seeking to diversify their product offerings and revenue streams. Building asset-based revenues is attractive to private fund managers because, in valuing a private fund manager, the multiples assigned to asset-based fees (which are relatively predictable) are generally higher than those assigned to performance-based revenues (which are not predictable). Other developments may also increase private fund manager interest in retail distribution opportunities:

   (a) The investment adviser of an investment company registered under the Investment Company Act of 1940 (the “1940 Act”) must be a registered investment adviser. The Dodd-Frank Act required the registration of many advisers to hedge funds and other private investment funds. This expanded the universe of private advisers eligible to sponsor and manage registered funds.

   (b) The approval by the Securities and Exchange Commission (the “SEC”) of final rules implementing the JOBS Act removes the ban of Regulation D on the use of general solicitations and advertising in connection with private offerings. This gives private fund managers the option of “branding” their businesses and may encourage some private fund managers to capitalize on the value of their brands by offering retail products.

6. A 1997 amendment of Subchapter M of the Internal Revenue Code of 1986 (the “Code”) (which governs the taxation of mutual funds) facilitated the ability of registered investment companies to make greater use of certain investment techniques associated with alternative investment strategies (such as short sales of securities) consistent with applicable qualification requirements.

B. Growth of Alternative Registered Funds

1. In February 2015, McKinsey & Company issued a report titled "The $64 Trillion Question: Convergence in Asset Management" that projects growth of the retail segment of the market will be a primary force behind the growth of alternative investments (particularly in the United States). The report estimates that by 2020, alternatives will comprise about 15 percent of global industry assets and produce up to 40 percent of industry revenues.

2. According to a recent *Bloomberg Business* article, liquid alternative funds had approximately $715 billion of total assets under management in 2015.[1] As of June 2015, there were approximately 652 alternative mutual funds in the U.S. market, according to a recent *Hedgeweek* special report.[2]

3. According to a 2015 report by PwC titled *Alternative Investments: It's Time to Pay Attention*, liquid alternative funds registered under the 1940 Act are expected to grow at a compounded annual growth rate of 18 percent from now until 2020. Another PwC report titled *Alternative Asset Management 2020: Fast Forward to Centre Stage* estimates the demand for liquid alternative mutual funds to increase from $260 billion at the end of 2013 to around $664 billion by 2020.

II. Benefits of 1940 Act Registration

A. Broader Flexibility in Offerings

1. Private investment funds relying on Section 3(c)(1) or Section 3(c)(7) of the 1940 Act for an exclusion from the 1940 Act definition of the term "investment company" are not required to register under the 1940 Act.

   (a) Section 3(c)(1) requires that a fund be sold in a private offering and limits the number of beneficial owners of interests in the fund to not more than 100 persons.

   (b) Section 3(c)(7) requires that a fund be sold in a private offering and that investors be limited to persons who are "qualified purchasers" as defined by Section 2(a)(51) of the 1940 Act (generally, individuals who own "investments" of $5 million or more and entities that own "investments" of $25 million or more).

   (c) The private offering requirements of Section 3(c)(1) and Section 3(c)(7) essentially require that offerings be made only to "accredited investors," as defined by Rule 501 of Regulation D under the Securities Act of 1933 (the "1933 Act") (generally, individuals having a net worth of more than $1 million or annual income in excess of $200,000).

2. Registration of a fund under the 1940 Act allows a fund to have more than 100 investors, without the need to sell interests in the fund only to qualified purchasers. This makes registered funds better suited to broad offerings by brokerage firms and financial advisory firms that have large numbers of clients, many of whom are not qualified purchasers. Also, the elimination of the 100-investor limit enables product sponsors to set lower minimum initial investment requirements without adversely affecting the amount of assets that can be raised.

3. A registered fund can make a public offering by registering its shares under the 1933 Act. A publicly offered fund need not limit its investors to persons who are "accredited investors," may use

[1] "Hedge Fund Copycats Draw Record Money as Clients Seek Safety" (Dec. 11, 2015).

[2] "The Ascent of Liquid Alternatives" (November 2015).

advertising and may offer its securities to persons with whom it does not have a pre-existing substantive relationship.

4. Like registered funds, business development companies ("BDCs") are not subject to various constraints applicable to private investment funds.

   (a) A BDC may sell its shares in a public offering.

   (b) There are no limitations that restrict the persons to whom shares of a BDC may be sold.

   (c) BDCs do not register under the 1940 Act. However, they are regulated in substantially the same way as registered funds, with certain exceptions.

5. Registered funds and BDCs may seek to qualify as "regulated investment companies" ("RICs") under Subchapter M of the Code. This enables the funds, under certain circumstances, to avoid entity-level taxation and to provide simplified tax reporting to investors on Form 1099.

6. Attachment A (Comparison of U.S. Alternative Fund Structures) provides a comparison of the structure and features of private investment funds to those of registered funds and BDCs.

B. Other Benefits of 1940 Act Registration

1. Generally, a private fund's assets will be deemed "plan assets" for purposes of the Employee Retirement Income Security Act of 1974 ("ERISA") if 25 percent or more of the value of interests in the fund are owned by ERISA plans. Section 401(b)(1) of ERISA, however, explicitly provides that the assets of a fund registered under the 1940 Act are not plan assets. Thus, regardless of the extent of ownership by employee benefit plans, a registered fund's assets will not be plan assets and ERISA constraints will not apply to the management and investment of those assets.

2. The adviser of a fund (whether a private fund or registered fund) that makes use of commodity futures and other commodity interests may be eligible for an exemption from registration as a commodity pool operator ("CPO") and registration as a commodity trading advisor if the fund trades a de minimis level of commodity interests. However, advisers of registered funds have a somewhat greater ability than private fund managers to avail themselves of exemptions from registration and avoid various regulatory requirements imposed by the Commodity Futures Trading Commission.

   (a) Rule 4.13(a)(3) under the Commodity Exchange Act of 1974 (the "CEA") provides an exemption from registration as a CPO to the manager of a private investment fund if the fund's use of commodity interests is limited so as to meet one of two de minimis tests and the fund is not marketed as a commodity pool or as a vehicle for trading in commodities.

   (b) The adviser of a registered fund may also avail itself of an exemption from CPO registration (pursuant to Rule 4.5 under the CEA) if similar requirements are met. However, in determining compliance by a registered fund with the de minimis tests, commodity interests used for "bona fide hedging" purposes need not be considered.

3. FINRA Rule 5130 (Restrictions on the Purchase and Sale of Initial Equity Public Offerings) prohibits broker-dealers from allocating to specified "restricted persons" shares being sold in public offerings of "new issues" of equity securities that trade at a premium in the secondary market. As a practical matter, the rule requires that private funds create a "carve out" so that profits from new issues are

allocated only to persons who are not restricted. The prohibitions of Rule 5130 do not apply to sales of new issues to registered funds.

III. Types of 1940 Act Registered Alternative Funds

A. Types of Funds

1. Registered funds are being used to deliver various types of alternative investment programs. Registered alternative funds include: single manager/strategy funds (e.g., long/short, market neutral, hedged equity); multi-manager alternative funds; private equity funds; funds of hedge funds and funds of private equity funds; and real asset/commodities funds.

2. Generally, registered alternative funds are organized either as closed-end funds or open-end funds (including open-end funds that operate as exchange-traded funds). The choice between these two structures is typically driven by the nature of a fund's investment program, the nature of its portfolio and consideration of other factors, including the fund characteristics/features desired by distribution channels.

(a) Open-end funds, by definition, are registered management investment companies that issue redeemable securities (i.e., shares that are redeemable at the option of the investor).

(b) A closed-end fund is a registered management investment company that does not issue redeemable securities.

(c) The provisions of Rule 22c-1 under the 1940 Act require that shares of open-end funds be redeemable on a daily basis. A closed-end structure avoids this requirement and thus enables greater control over the timing of cash flows to/from a fund. This structure may be required for funds that invest in illiquid securities but may also be appropriate for alternative investment strategies where dealing with daily cash flows might adversely affect investment performance.

(d) Under SEC interpretations of Section 22(e) of the 1940 Act, an open-end fund may not invest more than 15 percent of its assets in illiquid securities. Thus, an open-end structure is not feasible for registered alternative funds that invest a significant portion of their assets in securities that are illiquid (e.g., registered funds of hedge funds, registered private equity funds and certain distressed funds).

(e) Although a closed-end investment company issues interests that are not redeemable, investors in a closed-end fund can be provided with liquidity similar to the liquidity of an investment in a hedge fund by means of repurchase offers made by the fund, or can provide liquidity similar to the liquidity of an investment in a private equity fund by providing liquidity (by making distributions to investors) only as the fund's investments are sold or become liquid.

(f) Alternatively, as described in more detail below in III. C., shares of a registered closed-end fund can be listed for trading on a securities exchange, which provides daily liquidity to investors without impacting fund cash flows.

B. Non-Publicly Traded Closed-End Funds

1. A registered closed-end fund that is not traded on an exchange can be structured to have features similar to a private investment fund. Such a fund can be privately offered, impose a performance fee

or incentive allocation, be taxed as a partnership and provide periodic liquidity to investors through repurchase offers. A privately offered fund needs to comply with Regulation D under the 1933 Act and limit its investors to "accredited investors." In order to pay performance-based compensation, investors need to be "qualified clients." See III. D. below.

2. Non-publicly traded closed-end funds typically provide liquidity to investors by making offers to repurchase interests. Repurchase offers may be made in reliance on Rule 13e-4 (the issuer repurchase rule) under the Securities Exchange Act of 1934 Act (the "1934 Act") or in reliance on Rule 23c-3 under the 1940 Act (the "interval fund" rule). In both cases, interests in a fund are repurchased based on the net asset value of the interests, determined as of a specified valuation date.

   (a) Funds that do not rely on Rule 23c-3 cannot promise to make repurchase offers at specified periodic intervals. They can make discretionary repurchase offers on a recurring basis, but each such offer must be approved by the fund's board.

   (b) A fund that relies on Rule 23c-3 is required to make offers to repurchase at a specified interval (either quarterly, semi-annually or annually) and in each offer must offer to purchase a specified amount of interests equal to at least 5 percent, but not more than 25 percent of outstanding interests. Various other conditions are imposed by Rule 23c-3.

   (c) The conditions of Rule 23c-3 governing the timing and pricing of repurchase offers make it difficult for registered funds of hedge funds to rely on the rule. Such funds typically make repurchase offers in reliance on Rule 13e-4 under the 1934 Act.

   (d) A registered fund that elects to be taxed as a partnership must limit the frequency of its repurchase offers (and restrict transfers of interests) to avoid becoming a publicly traded partnership taxable as a corporation. Interests in the fund must not be redeemable or readily tradable. Semi-annual offers, and quarterly offers with a notice requirement of 65 days, are typically viewed as acceptable in this regard.

3. Depending on the combination of features that a non-publicly traded registered closed-end fund has, it can have the look and feel of a private investment fund or the look and feel of a mutual fund. The nature of the investor and the intended distribution channel generally play an important role in product design. For example, a large brokerage firm with retail distribution will generally prefer a more "investor friendly" product design, such as a publicly offered fund (which avoids the need to comply with rules applicable to private placements) that relies on Rule 23c-3 to make quarterly repurchase offers, does not pay performance-based compensation and is taxed as a "regulated investment company" under Subchapter M of the Code.

4. Public offerings by non-traded closed-end funds are subject only to notice filings under state "blue sky" laws.

C. Publicly Traded Closed-End Funds

   1. From an adviser's perspective, a publicly traded closed-end fund is a "permanent capital" vehicle (i.e., assets under management are not subject to decrease as a result of redemptions of shares or withdrawals of capital).

   2. Generally, these funds have very few 1940 Act limitations on the nature and type of their investments. As a result of their greater investment flexibility, publicly traded closed-end funds are

often used by asset managers in lieu of a "BDC" structure (which is further described in IV. below) to allow offshore or other investments that would be considered "bad" assets for a BDC.

3. As a practical matter, incentive fees on realized capital gains for publicly traded registered funds are not feasible. However, BDCs may pay performance fees based on net realized capital gains and both registered funds and BDCs may pay fees computed as a percentage of their income.)

D. Open-End Funds

1. Lately, there has been a growing number of registered open-end investment companies (mutual funds) that pursue alternative investment strategies, including multi-manager alternative funds that are sub-advised by private fund advisers that are each responsible for managing a "sleeve" of a single fund investment portfolio.

2. Rule 22c-1 under the 1940 Act requires that mutual funds determine the net asset value of their shares and honor requests for redemptions of shares on a daily basis. Under Section 22(e) of the 1940 Act, mutual funds must make payment of redemption proceeds within seven days absent certain specified extraordinary circumstances (such as when the New York Stock Exchange is closed other than for customary closings). Because of these requirements, the SEC and its staff take the position that mutual funds may not invest more than 15 percent of their assets in illiquid securities (10 percent in the case of money market funds).

3. Generally, mutual funds are publicly offered on a continuous basis, and investors can purchase shares on a daily basis. For this reason, mutual funds must periodically update their prospectuses and other disclosure documents by filing post-effective amendments to their registration statements with the SEC.

4. Generally, mutual funds need to qualify as RICs to avoid entity-level taxation (because the publicly traded partnership rules would preclude partnership taxation of a 1940 Act registered fund that provides daily liquidity).

5. Exchange-traded funds ("ETFs") are typically structured as open-end funds. Unlike a mutual fund, however, the shares of an ETF trade on a stock exchange at prices determined by the market.

   (a) Unique to an ETF is the process by which shares of an ETF are created. Large institutional investors and market makers have the ability to provide baskets of securities to an ETF in exchange for blocks of shares called "creation units" which shares can then be sold on an exchange. Similarly, shares of ETFs can be redeemed in creation units on an "in-kind" basis. It is this mechanism that, in large part, enables the prices at which ETF shares trade to closely reflect the net asset value of the shares.

   (b) ETFs can be index-based or actively managed.

E. Performance-Based Fees/Allocations

1. A registered fund that pays performance-based compensation (other than a fulcrum fee) cannot be listed for trading on a securities exchange because there presently are no mechanisms that would enable the fund to restrict ownership of its shares to investors who are qualified clients.

2. A registered fund can have a fee structure that is similar to that of private investment funds (e.g., an asset-based management fee and a performance-based incentive allocation or incentive fee that is a specified percentage of net profits) if interests in the fund are sold only to "qualified clients."

(a) Rule 205-3 under the Investment Advisers Act of 1940 (the "Advisers Act") provides an exemption from the general Advisers Act prohibition on performance fees where a fund is sold only to persons who are "qualified clients" (generally, a person with a net worth of more than $2 million, excluding the value of their principal residence, or who has at least $1 million under the management of the fund's adviser and its affiliates).

(b) Under the provisions of Rule 205-3, interests in a registered fund of hedge funds that does not impose a performance-based fee (or allocation) must also be sold only to qualified clients if the registered fund invests in any domestic hedge fund that: (i) has a performance-based compensation arrangement; (ii) relies on Section 3(c)(1) of the 1940 Act; and (ii) is managed by a registered adviser. (This results from a "look through" to the investors in the registered fund that is required by Rule 205-3 when determining whether investors in the underlying hedge fund are qualified clients.)

3. Section 205(b)(2) of the Advisers Act permits the adviser of a registered fund to receive compensation based on the net asset value of the fund averaged over a specified period and increasing and decreasing proportionately based on the investment performance of the fund measured over a specified period relative to the investment performance of an appropriate securities index. Such fees (called "fulcrum fees") must be computed in accordance with Rule 205-1 and Rule 205-2 under the Advisers Act.

IV. Business Development Companies

A. Characteristics of BDCs

1. A BDC is a closed-end management investment company that elects to be regulated under the BDC-related provisions of the 1940 Act in lieu of registering as an investment company under the 1940 Act. In many respects, a BDC is regulated under the 1940 Act in the same way as a registered closed-end fund.

2. Subject to certain requirements discussed below, BDCs may invest in equity securities or debt securities. A BDC that invests primarily in loans and other types of debt securities is essentially a hybrid between a public finance company and a registered investment company from a regulatory perspective and provides access to public capital markets.

3. Shares of a BDC may be offered publicly (and such shares may be listed for trading on a securities exchange) or may be offered in a private placement.

4. Privately offered BDCs may only be sold to accredited investors. Private BDCs are typically sponsored by private equity firms. In many cases, shares are offered through a private placement to the sponsor's existing investor base, rather than via a continuous public offering. BDCs following this model typically draw down capital via capital calls, similar to a private equity fund structure. A private BDC will generally target a future initial public offering and exchange listing.

5. BDCs are permitted by Section 205 of the Advisers Act to charge management fees and incentive fees similar to traditional private fund structures without any limitation as to whether its shareholders are qualified clients.

6. In exchange for greater regulatory flexibility, a BDC must invest 70 percent of its assets in "good" BDC assets. Such "good" or eligible assets are U.S.-organized, privately held (or "micro-cap" public) operating companies (non-3(c)(1) or -3(c)(7) entities). For these purposes, "micro-cap" companies are those with less than $250 million in public market capitalization.

7. A BDC must have at least a 200 percent asset coverage ratio (total assets to debt) at the time of any new borrowings. These asset coverage requirements are less stringent than those applicable to registered funds. See IX. A. below.

8. BDCs file annual, quarterly and current reports under the 1934 Act on the same basis and in the same manner as traditional public operating companies.

9. BDCs can elect to be taxed as RICs. The same qualification requirements under the Code that apply to registered funds apply to BDCs that seek to be taxed as RICs. Where a BDC is taxed as a RIC, tax-exempt investors may invest directly in the BDC, rather than through an offshore blocker. See VI. below.

B. Benefits of BDC Status

1. Unlike a private investment fund, a BDC is not required to limit the number of its investors or to sell its shares only to qualified purchasers.

2. Also, because a BDC (unlike a private investment fund) can make a public offering, it may advertise and sell its shares to investors who are not accredited investors.

3. A BDC can charge a performance fee without limiting its investors to qualified clients.

4. If a BDC elects to be taxed as a RIC, it may avoid entity-level taxation and provide tax reporting to investors on Form 1099, which is preferred by investors.

5. In certain respects, BDCs have somewhat greater flexibility under the provisions of the 1940 Act regulating transactions with affiliates.

C. BDC Management

1. The investment adviser of a BDC may be paid a performance fee that does not exceed 20 percent of the BDC's net realized capital gains. In addition, the adviser may earn an asset-based fee as well as a fee based on a percentage of the BDC's income.

2. Some BDCs are internally managed by employees of the BDC. Under these circumstances, employees can be compensated by the BDC through salaries and pursuant to a "profit-sharing plan" that pays out annually no more than 20 percent of the BDC's net income.

3. A BDC must "make available" to its investee companies "managerial assistance" (e.g., offer to serve on the company's board or to provide strategic consulting). A BDC may be compensated for providing these services.

D. Other Regulatory Considerations

1. BDCs must make regular public disclosures of their financial condition (financial statements, including a schedule showing each of their investments) on a quarterly basis (i.e., on Forms 10-Q and 10-K).

    (a) Following the last quarter of a fiscal year, the publicly disclosed financials statements (on Form 10-K) must be audited.

    (b) Quarterly and annual financial statements are subject to Sarbanes-Oxley certifications.

2. BDCs have ongoing 8-K reporting obligations and must disclose certain material corporate events promptly on Form 8-K.

3. A BDC may be restricted in its ability to co-invest with other funds and accounts managed by the investment adviser of the BDC. See V. B. below.

V. Key Implications of 1940 Act Regulation

A. Applicability of 1940 Act Investment Restrictions

1. Registered funds and BDCs are subject to various investment-related restrictions and limitations imposed by the 1940 Act. Among other things, these include restrictions on investments in the securities of securities-related issuers (Section 12(d)(3) of the 1940 Act) and limitations on the use of leverage (Section 18 of the 1940 Act), which imposes asset coverage requirements applicable to the issuance of "senior securities".[3]

2. The use of registered funds is feasible for delivering alternative investment strategies to investors only where the investment programs fit within the 1940 Act regulatory scheme. However, most hedge fund investment programs, including those involving short sales of securities, can be implemented consistent with requirements of the 1940 Act, except for certain highly leveraged strategies.

B. Prohibitions on Transactions with Affiliates

1. The 1940 Act and the rules thereunder contain various provisions (e.g., Section 17(a) and Rule 17d-1 for registered funds and Section 57 for BDCs) that generally prohibit affiliated persons of a registered fund or BDC, and affiliated persons of such persons, from engaging in any principal transaction, or any joint enterprise or other joint arrangement, with the registered fund or BDC.

2. The provisions of Rule 17d-1 (and Section 57(a)(4) with respect to BDCs) prohibiting joint enterprises need to be considered in connection with the purchase or sale of privately offered securities where both a registered fund and any of its affiliated persons (including other funds) are purchasing or selling the same securities.[4]

3. BDCs frequently obtain SEC exemptive orders permitting co-investments with affiliated funds that would otherwise be prohibited pursuant to Section 57(a)(4).[5]

4. The prohibition of Section 17(a) on affiliated transactions must also be considered when managing a registered fund of hedge funds. Generally, a private fund in which a registered fund of hedge funds proposes to invest may be an affiliated person of the registered fund if: (i) the adviser of the registered fund of funds serves as or is affiliated with the general partner/adviser of the private fund; (ii) the registered fund of funds owns five percent or more of the outstanding voting securities of the private fund; or (iii) funds and other accounts managed by the adviser of the registered fund of funds own, in the aggregate, five percent or more of the outstanding voting securities of the private fund (Section 2(a)(3) of the 1940 Act). For this reason, registered funds of hedge funds (and their affiliates) typically purchase a class of non-voting securities of the underlying fund or contractually waive their voting rights when investing in private funds.

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[3] *See* VIII. A., *infra*.

[4] *See* VIII. D. 1., *infra*.

[5] *See also* IX. C., *infra*.

5. Although Section 17(a) generally prohibits a registered fund from purchasing securities from or selling securities to an affiliated person of its investment adviser (including private investment funds managed by the registered fund's investment adviser), such transactions are permitted by Rule 17a-7 under the 1940 Act in the case of securities for which market quotations are readily available if the registered fund is affiliated with the other party to the transaction solely by reason of having the same investment adviser (or an affiliated adviser), common directors and/or common officers. Rule 17a-7 may not be available to permit cross-trades between a registered fund and a private fund where the funds are affiliated as a result of the adviser of the funds serving as general partner or owning 5 percent or more of the interests in the private fund.

6. Section 17(e)(2) of the 1940 Act and Rule 17e-1 thereunder generally permit the use of a broker-dealer affiliated with the registered fund's adviser to effect securities transactions on an agency basis, subject to a condition that the commissions paid to the affiliated broker not exceed the "usual and customary" broker's commission.

C. "Corporate Governance" Requirements

1. The 1940 Act imposes certain governance requirements under which registered funds and BDCs are required to have "independent directors" and requires that various matters be approved by these directors (and, in some cases, also approved by fund shareholders).

2. Among other requirements, investment advisory agreements and distribution agreements of registered funds and BDCs must be approved by a majority of the independent directors. These agreements may have initial terms of two years and can continue in effect thereafter only if approved annually by a majority of the independent directors. In addition, the agreements must provide for automatic termination in the event of an "assignment" and for termination by the registered fund or BDC on not more than 60 days' notice.[6]

3. In recent enforcement proceedings against investment advisers in connection with the advisory agreement renewal process under Section 15(c) of the 1940 Act, the SEC has found that boards of directors were furnished with incomplete information (and in one case, that the board also failed to request sufficient information) and that shareholder reports misrepresented material information pertinent to the renewal process.[7]

D. Record-Keeping Rules and SEC Examinations

1. Rule 31a-1 under the 1940 Act requires that registered funds and BDCs maintain certain specified books and records.

2. Section 31(b) of the 1940 Act provides that these books and records are subject to reasonable periodic, special and other examinations by the SEC and its staff.

E. Public Reports

1. Registered funds must send audited annual reports and unaudited semi-annual reports to their investors within 60 days after the end of the applicable fiscal period. These reports, which are filed with the SEC and publicly available, contain financial statements, including statements of investments that identify all investments held by the funds. In addition, registered funds must file

[6] *See* Section 15 of the 1940 Act.

[7] *In the Matter of Kornitzer Capital Management, Inc. and Barry E. Koster*; *In the Matter of Commonwealth Capital Management, LLC, et al.*; *In the Matter of Northern Lights Compliance Services LLC, et al.)*

reports with the SEC showing their investment holdings as of the end of their first and third fiscal quarters.

(a) Sarbanes-Oxley certification requirements are applicable to these filings and require that a registered fund's principal executive officer and principal financial officer certify the accuracy of the information contained in a registered fund's reports.[8] In addition, a registered fund must maintain disclosure controls and procedures and internal control over financial reporting as required by Rule 30a-3 under the 1940 Act.

(b) The SEC has recently proposed the adoption of new reporting requirements for registered funds that would expand the disclosure and reporting obligations of registered funds and require investment information to be filed with the SEC on a more frequent basis.[9]

2. BDCs file annual, quarterly and current reports under the 1934 Act on the same basis and in the same manner as traditional operating companies.[10]

3. Pursuant to Section 32(a) of the 1940 Act and related rules, the independent registered public accounting firm of a registered fund and a BDC must be selected by the vote of a majority of the independent directors at an in-person meeting.

F. Fund Administration and Compliance

1. Operating registered funds and BDCs requires implementation of systems to assure compliance with the 1940 Act and other laws.

(a) Rule 38a-1 under the 1940 Act requires that registered funds and BDCs adopt policies and procedures reasonably designed to prevent violations of the federal securities laws. A registered fund must also appoint a chief compliance officer ("CCO"). A fund's compliance program and its CCO must be approved by the independent directors of the fund, and the independent directors must also approve the CCO's compensation.

(b) On an annual basis, the CCO must review the adequacy of the compliance program and provide a report to the fund board regarding that review.

(c) There is no prohibition on the CCO of a fund also serving as CCO of the fund's adviser.

2. Registered funds and BDCs require various administration, fund accounting and transfer agent services in connection with their operations. An outside administrator and transfer agent can be retained by a fund to supply these services. Frequently, the services provided by an administrator will include supervision of regulatory and tax compliance.

VI. Taxation of Registered Funds and BDCs

A. Taxation Options

1. Most registered funds and BDCs seek to qualify as RICs under Subchapter M of the Code. This enables the funds to avoid entity-level taxation if certain required distributions are made to investors and also enables the funds to provide simplified tax reporting to investors on Form 1099.

[8] Rule 30a-2 under the 1940 Act.

[9] *Investment Company Reporting Modernization*, ICA Rel. No. IC-31610 (May 20, 2015).

[10] *See* IV. D, *supra*.

2. Registered closed-end funds can also opt to be taxed as partnerships, in which case tax reporting to investors is provided on Schedule K-1. If a registered fund is taxed as a partnership, it does not have to meet the requirements of the Code applicable to RICs.

3. There is a strong preference in retail distribution channels for tax reporting on Form 1099. However, when it is anticipated that concentration of a fund's investment positions or the sources of its income will preclude RIC qualification, a registered closed-end fund taxable as a partnership may be the only viable option.

4. Registered funds and BDCs that qualify as RICs are treated as corporations for tax purposes. Thus, there is no flow through to U.S. tax-exempt investors in such funds of unrelated business taxable income (UBTI).

5. Funds taxed as partnerships are typically organized as limited liability companies or limited partnerships. Funds taxed under Subchapter M are typically organized as business (or statutory) trusts or as corporations.

B. RIC Qualification

1. To qualify as a RIC, a registered fund or BDC must meet a quarterly diversification test as well as an annual test relating to the sources of its income.

(a) Under the diversification test, as of the end of each taxable quarter, at least 50 percent of a RIC's assets must be represented by: cash; U.S. government securities; securities of other RICs and other securities as to which the RIC's investment is limited in respect to any issuer to an amount not greater than five percent of the value of the RIC's total assets and not greater than 10 percent of the outstanding voting securities of such issuer. In addition, a RIC generally may not invest more than 25 percent of its assets in the securities (other than U.S. government securities and securities of other RICs) of any one issuer or in the securities of one or more qualified publicly traded partnerships.

(b) Under the source of income test, at least 90 percent of a RIC's gross income during its taxable year must be derived from: dividends; interest; payments with respect to securities loans; gains from the sale or other disposition of stock; securities or foreign currency; certain other income (including, but not limited to, gains from options, futures and forward contracts) derived with respect to its business of investing in stock, securities or currencies; or from net income derived from an interest in a qualified publicly traded partnership. For purposes of this test, non-qualifying (or "bad") income would include income derived from: non-financial commodities; direct ownership of real estate and rents from real property; certain unincorporated entities; and intangibles, such as trademarks, patents and royalties.

2. RICs sometimes use "blocker" entities taxable as corporations for U.S. tax purposes to hold investments that would generate bad income if held directly by a RIC in order to facilitate their investment programs.

VII. Multi-Manager Alternative Funds

A. Fund Features

1. Over the past few years, many mutual fund groups and fund of hedge funds managers have launched multi-manager mutual funds that pursue alternative investment strategies and hire private

fund managers as sub-advisers. Each sub-adviser has responsibility for managing a designated portion of the fund's portfolio allocated to it by the fund's adviser.

2. Sub-advisory agreements are entered into by the advisers (rather than by the funds) and the fees payable to the sub-advisers are typically paid by the advisers.

3. The funds obtain exemptive orders from the SEC pursuant to which sub-advisory agreements entered into with sub-advisers need not be approved by fund shareholders. The orders also provide exemptions under which the fee paid to each sub-adviser need not be publicly disclosed (although disclosure of aggregate fees paid to all sub-advisers is required).

B. Sub-Advisory Agreements

1. Sub-advisory agreements require the sub-advisers to manage the funds' assets consistent with fund investment policies and restrictions, applicable law and the requirements of Subchapter M. In most cases, the agreement requires the sub-adviser to manage its designated portion of the fund's assets as though it constitutes all of the fund's assets (which facilitates compliance by the fund with applicable investment-related restrictions) measured as a percentage of the fund's assets.

2. The agreements sometimes specify investment parameters that the sub-adviser will be expected to follow in managing the fund's assets (which are intended to control risk exposures and achieve desired risk/return characteristics). These parameters may be more restrictive than what is required under a fund's policies or by the 1940 Act.

3. In many cases, the sub-advisory agreement (or a separate agreement between the adviser and sub-adviser) may include additional terms relating to the sub-advisory relationship, such as: exclusivity provisions; a requirement that the sub-adviser charge a fee that is the lowest it charges to similarly-situated clients (i.e., a "most favored nation" or "MFN" provision); or an agreement relating to "capacity" (i.e., that the sub-adviser will agree to accept additional assets from the fund allocated to it by the adviser up to a specified amount). Careful consideration should be given to the nature of these supplemental provisions to assure that they do not involve arrangements intended to benefit the adviser or sub-adviser (and not the fund).

C. Supervision of Sub-Advisers

1. The adviser of a multi-manager mutual fund has a responsibility to supervise the services provided by each sub-adviser and to monitor those services for compliance with applicable investment policies and restrictions and applicable law.

2. Because private fund managers of registered funds often have little or no experience managing the assets of registered funds, it is important that advisers of multi-manager mutual funds conduct appropriate due diligence to assure themselves that prospective sub-advisers have implemented procedures and controls needed to assure investment-related compliance.

(a) The due diligence process for sub-adviser selection should include consideration of whether a prospective sub-adviser has effective procedures that address compliance with 1940 Act requirements and Subchapter M.

(b) Areas of focus should include: policies regarding trade allocations; trade error policies; procedures to comply with 1940 Act leverage limits; policies regarding the use of "soft dollars"; and expense allocation practices. Certain sub-adviser policies and practices used in connection with managing private funds may not be permissible or acceptable when managing the assets of registered funds.

(c) Advisers of multi-manager mutual funds need effective systems to monitor compliance with investment-related restrictions and regulatory requirements that are based on ownership of specified percentages of an issuer's outstanding securities that cannot fully be controlled by the individual sub-advisers (e.g., beneficial ownership reporting under the 1934 Act and Subchapter M diversification requirements).

(d) Generally, sub-advisers should be required to adhere to fund adopted policies governing various matters, such as policies relating to the use of affiliated brokers (Rule 17e-1 procedures), cross-trades (Rule 17a-7 procedures); and purchases of securities in underwritten offerings in which an affiliated broker is a participant (Rule 10f-3 procedures).

(e) In the absence of definitive SEC guidance, there have been varying practices, regarding how to comply with asset segregation requirements applicable to certain types of derivatives. For this reason, advisers and sub-advisers should agree on the asset segregation procedures that will be used for various types of derivatives. However, the SEC has recently proposed a new rule regulating the use of derivatives by registered funds and BDCs that will, if adopted, impose specified asset segregation requirements.[11]

D. Board Oversight

1. The board of a multi-manager alternative mutual fund has important oversight responsibilities in connection with the operations of the fund.

2. Among other things, boards need to evaluate: the adviser's capabilities and experience in selecting sub-advisers; the controls in place to monitor services provided by sub-advisers and overall fund compliance with applicable investment-related restrictions; and whether sub-advisers have adequate procedures and controls to assure compliance with the 1940 Act and other legal requirements.

VIII. Registered Funds of Hedge Funds

A. Fund Characteristics

1. Registered funds of hedge funds are structured as closed-end funds.

2. Interests in registered funds of hedge funds have been offered in both private and public offerings.

3. The form of organization has typically been a limited liability company or limited partnership, except for funds that have elected to be taxed as RICs, which have typically been organized as trusts.

4. Interests in registered funds of hedge funds have not been publicly traded. These funds have provided liquidity to investors by means of repurchase offers, which are generally made pursuant to Rule 13e-4 under the 1934 Act.

B. Application of 1940 Act Provisions

[11] *See* IX. A . 6, *infra*.

1. The “fund of funds” restrictions of Section 12(d)(1) of the 1940 Act were amended in 1996 and no longer restrict the ability of a registered fund to invest in hedge funds or other types of private investment funds.

2. Investment in any one underlying hedge fund should not exceed 40 percent of a registered fund’s assets. An investment in excess of this amount could result in the registered fund being deemed to be “formed for the purpose” of investing in the hedge fund, which would require the hedge fund to “look through” to the investors in the registered fund in determining its eligibility to rely on the exclusions made available by Section 3(c)(1) and Section 3(c)(7) of the 1940 Act. This “look through” requirement would likely result in the hedge fund being unable to rely on either of those exclusions because the registered fund will probably have more than 100 investors and have investors who are not qualified purchasers.

3. A hedge fund relying on Section 3(c)(1) of the 1940 Act needs to prohibit any registered fund from purchasing 10 percent or more of its outstanding interests. The purchase by a registered fund of an interest exceeding this limit would require the hedge fund to count investors in the registered fund as its beneficial owners for purposes of the Section 3(c)(1) requirement limiting beneficial owners to not more than 100 persons.

4. Assuming a registered fund does not “control” the hedge funds in which it invests, the hedge funds will generally not be subject to any of the provisions of the 1940 Act. (Under Section 2(a)(9) of the 1940 Act, control is presumed when a company owns more than 25 percent of the outstanding voting securities of another company).

5. However, the affiliated transaction prohibitions of the 1940 Act can become applicable to a hedge fund that accepts an investment from a registered fund.

   (a) Under Section 2(a)(3) of the 1940 Act, ownership by a registered fund of 5 percent or more of the outstanding “voting securities” of a hedge fund would cause the registered fund and the hedge fund to be affiliated persons of one another. Affiliation could also arise in other ways. For example, if the adviser of a registered fund manages funds (whether or not registered) and other accounts that, in the aggregate, own more than 5 percent of the voting securities of a hedge fund, the hedge fund would be an affiliated person of an affiliated person of the registered fund.

   (b) If the hedge fund is an affiliated person of a registered fund (or an affiliated person of such a person), Section 17(a) of the 1940 Act would generally prohibit the hedge fund from selling interests in such fund to the registered fund and prohibit the hedge fund from repurchasing such interests from the registered fund.

   (c) The term “voting security” is defined by Section 2(a)(42) of the 1940 Act to mean any security presently entitling the owner to vote for the election of directors of a company. However, the circumstances under which interests in a hedge fund should be considered voting securities are unclear. For this reason, registered funds of hedge funds, and other funds and accounts managed by the same investment adviser, typically purchase a class of non-voting securities of a hedge fund, or enter into irrevocable contractual waivers of their voting rights, to assure that their interests in the hedge funds are not voting securities. This practice enables registered funds of hedge funds and their affiliated persons to own, in the aggregate, 5 percent or more of the outstanding interests in a hedge fund. The SEC staff has not provided any written guidance relating to this practice, but has not objected to use of these arrangements.

(d) Even in circumstances where voting rights have been waived or where a non-voting share class of a hedge fund is owned, significant ownership of the outstanding interests in a hedge fund may possibly cause the interests owned by a registered fund, and by funds and accounts managed by the registered fund's adviser, to be de facto voting securities.[12]

IX. Other Regulatory Considerations

A. Leverage and Use of Derivatives

1. Many registered alternative funds use short sales and derivatives in connection with their investment programs. These practices may be deemed to result in the issuance of "senior securities" subject to the limitations of Section 18 of the 1940 Act.

2. Generally, Section 18 of the 1940 Act imposes a 300-percent asset coverage requirement on closed-end investment companies with respect to the issuance of senior securities constituting indebtedness (which means that a fund needs $3 in total assets to cover $1 of borrowings). In the case of open-end investment companies, Section 18(f) of the 1940 Act generally prohibits the issuance of senior securities, but permits borrowings from a bank subject to maintaining 300-percent asset coverage.

3. BDCs are subject, under Section 61 of the 1940 Act, to a 200-percent asset coverage limitation.

4. Under interpretations issued by the SEC and its staff, an investment position of a fund will constitute a senior security for 1940 Act purposes if it creates a potential future payment or delivery obligation on the part of the fund. Transactions that are viewed as creating senior securities include: short sales, writing options, futures transactions, swaps, forwards, reverse repurchase agreements and when-issued commitments. However, generally, these transactions will not be deemed senior securities if a fund segregates on its books (or on the books of its custodian bank) liquid assets having a value (marked-to-market daily) at least equal to the amount of its potential obligations.[13]

5. Some registered alternative funds may use derivatives to facilitate implementation of investment exposures that they might not otherwise be able to achieve consistent with 1940 Act investment-related restrictions.

6. On Dec. 11, 2015, the SEC issued a release proposing to adopt new Rule 18f-4 under the 1940 Act.[14] The proposed rule, if adopted, will regulate the use of derivatives by registered funds and BDCs and will also regulate other trading practices of such funds that are deemed to involve the issuance of "senior securities," including short sales of securities.

(a) The proposed rule represents the SEC's efforts to provide a clearer regulatory framework applicable to the use of derivatives by regulated funds. As explained in the SEC release, Rule 18f-4 is "designed to address the investor protection purposes and concerns underlying section 18 [of the 1940 Act] and to provide an updated and more comprehensive approach to the regulation of funds' use of derivatives transactions."

[12] *See Wells Fargo Alternative Asset Management, LLC* (pub. avail. Jan. 26, 2005).

[13] *See, e.g.*, *Securities Trading Practices of Registered Investment Companies*, ICA Rel. No. 10666 (April 18, 1979); *Dreyfus Strategic Income* (pub. avail. June 22, 1987); *Robertson Stephens Investment Trust* (pub. avail. Aug. 24, 1995); and *Merrill Lynch Asset Management, L.P.* (pub. avail. July 1, 1996).

[14] *Use of Derivatives by Registered Investment Companies and Business Development Companies,* ICA Rel. No. 31933 (Dec. 11, 2015).

(b) The proposed rule would, subject to various conditions, provide regulated funds with an exemption from Section 18's restrictions on the issuance of "senior securities" in connection with effecting derivatives and financial commitment transactions. If adopted, the provisions of the rule will supersede prior guidance of the SEC and its staff relating to these matters.

B. Trade Allocations

1. Investment advisers have a fiduciary duty to treat all clients fairly. Thus, advisory firms that manage both traditional mutual funds (or other "long only" accounts) as well as funds or other accounts that pursue alternative investment strategies need to assure that their policies on trade allocations appropriately address conflicts that may exist as a result of differing trading strategies or as a result of the fact that the firm receives greater compensation for managing funds and accounts that use alternative investment strategies (possibly including performance-based fees or allocations). The conflict is particularly acute in circumstances where the same portfolio managers have responsibility for both types of accounts and where investment personnel have a direct participation in revenues derived from accounts that they manage.

2. One way to mitigate these conflicts is to establish information barriers between personnel involved in managing hedge funds (or other alternative strategy accounts) and other investment personnel within the firm. However, this is not always feasible or practicable.

3. If information barriers are not established, trade allocation procedures must be implemented to assure that no client accounts are disadvantaged where there are non-pro rata allocations (e.g., the firm's hedge funds purchase or sell a security that is not also purchased or sold by the firm's registered funds) and to deal with conflicts arising from the fact that short sales effected for certain accounts may adversely affect other accounts (e.g., the firm's hedge funds selling short a security held long by the firm's registered funds) and other trading practices that might be viewed as unfair to any client (e.g., the hedge funds purchase thinly traded securities shortly after significant sales of the same securities by the registered funds).

   (a) Procedures should require either: (i) independent approval of specified types of transactions (i.e., approval by someone other than the portfolio manager); or (ii) the preparation by the portfolio manager of a contemporaneous memorandum of the trading decision which sets forth the rationale for the trade and the differing decisions made for different clients.

   (b) Back-end monitoring of trading patterns should be used to identify potentially abusive practices.

4. A firm's trade allocation policies should be disclosed in its Form ADV, and appropriate disclosure should also be included in a fund's offering documents.

C. Co-Investments

1. Rule 17d-1 generally prohibits an affiliated person of a registered fund or a BDC (or an affiliated person of such a person) from entering into any "joint enterprise or other joint arrangement" in which the registered fund or the BDC is also a participant absent an exemptive order issued by the SEC.

2. The SEC staff has taken the position that co-investments in privately placed securities made by a registered fund and other accounts managed by the fund's adviser may be prohibited by Rule 17d-1

unless various conditions are met.[15] The staff took a no-action position in *MassMutual*, allowing co-investments in privately placed securities, subject to certain conditions. One of those conditions is a requirement that no terms of the transaction are negotiated other than "price."

3. Because BDCs generally invest in privately negotiated transactions and are often part of a complex of other private or registered funds managed by the same adviser (i.e., affiliated persons of the BDC) that seek to participate in the same investment transactions, BDCs must be cognizant of the joint transaction prohibitions of Section 57(a)(4) of the 1940 Act and Rule 17d-1. For this reason, many BDCs have applied for and obtained SEC orders pursuant to Section 57(a)(4) and Rule 17d-1 permitting co-investments, subject to various conditions.

D. Use of Side Letters

Investors in hedge funds and other private investment funds sometimes enter into "side letters" with the managers of these funds to obtain various rights that are not given to all investors (e.g., more favorable withdrawal rights, reduced fees, transparency and indemnification rights). When the adviser of a registered fund of hedge funds also manages one or more unregistered funds of hedge funds, the use of side letters may raise an issue under Rule 17d-1 under the 1940 Act because of the SEC's position in *MassMutual*. Registered funds of hedge funds should implement procedures to address this potential issue.

E. Valuation Issues

1. Some alternative investment strategies may involve the purchase of investments that are illiquid or otherwise hard to value. These may include investments in privately placed (or restricted) securities, thinly traded securities, interests in private investment funds or complex derivatives.

2. Valuation of investments and related internal controls is an area of SEC regulatory focus and has been the subject of SEC enforcement actions.[16]

3. Interests in hedge funds and other private investments are illiquid and market quotations for these securities are not available. Section 2(a)(41) of the 1940 Act requires that these interests be valued at their "fair value," as determined in good faith by the board of directors of a registered fund. A registered fund investing in hedge funds will generally have to rely on valuation information supplied by the managers of the underlying private funds in which the registered fund invests. Because transparency to the underlying hedge fund portfolios is not always available, the adviser of a registered fund may have no means of verifying the valuations provided by the hedge fund managers.

   (a) In its September 2003 report, *Implications of the Growth of Hedge Funds* (the "Hedge Fund Report"), the SEC staff recommended that the SEC adopt a rule under the 1940 Act prohibiting registered funds from investing in hedge funds unless their boards of directors adopt procedures designed to ensure that interests in hedge funds are valued consistently with the requirements of the 1940 Act.

   (b) The SEC has not proposed the adoption of such a rule. However, comments of the SEC staff given in connection with its reviews of registration statements filed by registered funds of hedge funds have essentially required the adoption of procedures addressing the valuation of interests in hedge funds.

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[15] *Massachusetts Mutual Insurance Company* (pub. avail. June 7, 2000) ("*MassMutual*").

[16] *See, e.g.*, *In the Matter of Morgan Asset Management, Inc., et al.*, ICA Rel. No. 29704 (June 22, 2011).

4. Registered funds and BDCs must adopt procedures governing the valuation of securities for which market quotations are not readily available. These procedures should identify the factors and methodologies that will be used to value the specific types of investments that are held.

X. Regulatory Focus on Alternative Registered Funds

A. Distribution and Sales Practices

1. In the Hedge Fund Report, the SEC staff stated that it did not find evidence of significant numbers of retail investors investing directly in hedge funds.

   (a) The staff recognized, however, that investments in registered funds of hedge funds expose retail investors to hedge fund-related risks and urged the SEC and the NASD, now the Financial Industry Regulatory Authority ("FINRA"), examination staffs to be "vigilant" in identifying violations by broker-dealers of their suitability obligations to customers.

   (b) SEC staff concerns related primarily to the "downstreaming" of hedge fund risks to retail investors through registered funds of hedge funds (because the hedge funds in which the registered funds invest are not subject to regulation under the 1940 Act).

2. Notice to Members 03-07 (*NASD Reminds Members of Obligations When Selling Hedge Funds*) summarized the obligations of broker-dealers selling hedge funds, including registered funds of hedge funds, to their customers as follows:

   (a) Sales Materials: Hedge fund-related sales materials must be fair and balanced and must fully disclose risks. (NASD Conduct Rule 2210 — *Communications with the Public* — is applicable to advertising and sales literature relating to registered hedge funds. Among other things, it requires that the content of such materials meet the standards and requirements of Rule 2210 and that the materials be filed with FINRA).

   (b) Suitability: FINRA members selling interests in hedge funds must have a reasonable basis for recommending a particular strategy or investment to a customer. Members must make a "reasonable basis" suitability determination regarding each hedge fund they offer to customers based on product-specific due diligence. Members must also make a "customer specific" suitability determination before recommending a particular hedge fund to a customer (as required by NASD Conduct Rule 2310) based on the customer's financial and tax status, the customer's investment objectives and such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer. A customer's specific level of assets does not, by itself, satisfy a member's obligation to determine customer suitability.

   (c) Internal Controls: Members must have internal controls, including supervisory and compliance procedures, to ensure that sales of hedge funds comply with all relevant FINRA and SEC rules, and they must be able to demonstrate compliance with those procedures.

   (d) Training: Members must train associated persons about the characteristics of, and risks associated with, hedge funds before they allow their associated persons to recommend hedge funds to customers.

3. FINRA issued an Investor Alert to inform investors of matters, including risks, that they should consider when making decisions to invest in registered alternative funds.[17]

4. FINRA has conducted examinations of hedge fund sales literature used by broker-dealers and brought a number of enforcement actions against firms based on their use of sales literature that violated the standards of Rule 2210. FINRA has also conducted examinations of certain broker-dealers to determine if hedge funds (including registered hedge funds) are being sold to smaller retail investors for whom such investments may not be suitable.

5. In July 2015, the Massachusetts Securities Division launched an examination into the sales by state registered investment advisers of a number of alternative mutual funds in order to determine whether the firms properly recommended the alternative mutual funds to retail clients in the state. The inquiry resulted in an alert issued by the Massachusetts Securities Division in which it addressed a number of its concerns relating to the offer and sale of various investment products to retail investors.[18]

6. FINRA's 2016 Regulatory and Examination Priorities Letter (Jan. 5, 2016) identifies practices relating to sales of alternative products, including alternative mutual funds, as an area of focus.

    (a) In this letter, FINRA notes that these products require additional scrutiny by broker-dealers in arriving at suitable recommendations for their customers. It also notes the importance of adequate due diligence with respect to alternative products, the need for appropriate review of these products by new product review committees, and the training of registered representatives to assure their understanding of products recommended to customers.

    (b) FINRA cautions that broker-dealers should monitor for excess concentration of risky products in customer accounts.

B. OCIE Examination Priorities

1. The SEC's Office of Compliance Inspections and Examinations ("OCIE") indicated that "alternative investment companies" would be an area of focus in connection with its examinations in 2015.[19]

2. OCIE indicated that it will continue its assessment of funds offering alternative strategies and that it will focus on: (i) leverage, liquidity and valuation policies and practices; (ii) staffing, funding and empowerment of boards, compliance personnel and back-offices; and (iii) the manner in which these funds are marketed to investors.

C. Due Diligence in Selecting Alternative Investments and Their Managers

1. In a National Exam Program Risk Alert (the "Risk Alert"),[20] OCIE set forth its observations regarding trends in due diligence processes used by investment advisers in selecting alternative investment funds for their clients. The observations, which were based on examinations of advisers to pension

[17] FINRA, Investor Alert: Alternative Funds Are Not Your Typical Mutual Fund (June 12, 2013), *available at* www.finra.org/investors/alerts/alternative-funds-are-not-your-typical-mutual-funds.

[18] *See* Guidance in Connection with the Retail Sales of Structured Products by Massachusetts Registrants (Oct. 26, 2015), *available at* www.sec.state.ma.us/sct/ sctguidance/guidance.pdf.

[19] National Exam Program, Examination Priorities for 2015 (Jan. 13, 2015), *available at* www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf.

[20] Investment Adviser Due Diligence Processes for Selecting Alternative Investments and Their Respective Managers (Jan. 28, 2014), *available at* www.sec.gov/about/offices/ocie/adviser-due-diligence-alternative-investments.pdf.

funds and private funds of funds conducted by OCIE, are also relevant to the procedures used by the advisers of multi-manager mutual funds in selecting and monitoring sub-advisers.

2. Among other things, OCIE noted in the Risk Alert that:

   (a) Advisers are seeking more information and data from managers of alternative investments (e.g., position-level transparency) and requesting that assets of their clients be managed as separate accounts to enhance transparency, controls and the monitoring of liquidity and valuation, and to reduce the risk of misappropriation of assets or the charging of unauthorized fees or expenses.

   (b) Advisers are using third parties to supplement analyses and validate information. Practices in this area include: (i) the use of portfolio information aggregators (risk aggregators) to obtain a better understanding of portfolio level risk; (ii) third-party verification of service provider relationships and assets being held or serviced by the service provider; (iii) investing in funds that have independent administrators or provide transparency reports from administrators; (iv) use of third parties to perform background checks on managers and their key personnel; and (v) regulatory history review (e.g., use of FINRA BrokerCheck and review of regulatory filings such as Form ADV).

   (c) Advisers are enhancing and expanding their processes by focusing on operational due diligence matters (such as a review of managers' valuation policies and procedures), reviewing legal documents, assessing fund liquidity terms and portfolio liquidity, conducting onsite visits, and conducting more detailed reviews of audited financial statements.

3. The Risk Alert also enumerates matters identified in the due diligence process that advisers view as warning indicators of risks relating to investments, operations and risk management. In addition, the Risk Alert discusses certain deficiencies that OCIE identified in its examinations: (i) failure to include review of due diligence procedures as part of the annual compliance review required by Rule 206(4)-7 under the Advisers Act; (ii) deviation of actual due diligence practices from disclosures and failure to review disclosures for consistency with fiduciary principles; and (iii) potentially misleading or unsubstantiated claims relating to the due diligence process in marketing materials.

Attachment A: Comparison of U.S. Alternative Fund Structures

	Domestic Hedge Fund	**Domestic Private Equity Fund**	**Closed-End Fund/Non-Publicly Traded**	**Closed-End Fund/Publicly Traded**	**Publicly Traded Business Development Company**	**Mutual Fund**
Typical Investments	Primarily liquid investments	Primarily illiquid investments (equity, debt or other assets)	May include liquid or illiquid investments (equity, debt or other assets)	May include liquid or illiquid investments (equity, debt or other assets)	Primarily illiquid equity or debt of private companies (and securities of micro-cap companies)	Primarily liquid investments
Key Restrictions on Investments	None	None	Leverage limitation (300% asset coverage on debt)	Leverage limitation (300% asset coverage on debt)	Leverage limitation (200% asset coverage)	Leverage limitation (300% limitation on debt; only "senior securities" may be bank borrowings)
Form of Entity	Partnership or LLC	Partnership or LLC	Corporation, trust, partnership or LLC	Corporation or trust	Corporation or trust	Corporation or trust
Governance	General partner or managing member	General partner or managing member	General partner, managing member, directors or trustees	Directors or trustees	Directors or trustees	Directors or trustees
Tax Status	Partnership	Partnership	Partnership or Subchapter M	Subchapter M	Subchapter M	Subchapter M
1940 Act Status	Excluded by Section 3(c)(1) or 3(c)(7)	Excluded by Section 3(c)(1) or 3(c)(7)	Registered	Registered	Subject to BDC provisions of the 1940 Act	Registered
Manner of Offering	Private offering	Private offering	Public or private offering	Public offering	Public offering	Public offering
Investor Qualification Requirements	Accredited investors, qualified purchasers	Accredited investors, qualified purchasers	Accredited investors (if privately offered)	No restrictions	No restrictions	No restrictions
Performance-Based Allocation or Fee	Yes	Yes	Yes (if investors are limited to "qualified clients")	No	Yes (without requirement that investors be "qualified clients")	No

	Domestic Hedge Fund	Domestic Private Equity Fund	Closed-End Fund/Non-Publicly Traded	Closed-End Fund/Publicly Traded	Publicly Traded Business Development Company	Mutual Fund
Liquidity	Periodic (quarterly, semi-annually or annually, potentially with lock-ups and/or gates)	None; fund typically has 7- to 10-year term	Periodic repurchase offers (not more frequently than quarterly)	Exchange-traded	Exchange-traded	Daily liquidity at current NAV

The New Anti-Money Laundering Rule

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Brad focuses his practice on counseling hedge funds and private equity funds on operational, regulatory and compliance matters. He represents clients on a broad range of issues, including those related to the U.S. Investment Advisers Act, other federal, state and self-regulatory organization requirements and securities trading rules in the United States. Brad also provides guidance to clients with operations in Hong Kong, Japan and other markets throughout Asia and the United Kingdom with respect to regulatory, compliance, trading and operations. Prior to joining Schulte Roth & Zabel, Brad served for 12 years in various in-house roles, including as general counsel and chief compliance officer of investment advisers ranging from multibillion-dollar funds to start-ups, and as a member in the asset management group of a leading investment bank.

A frequent speaker and writer on the topics of fund operations and regulatory compliance, Brad most recently presented on market terms and regulatory issues for co-investments, regulatory changes to Form ADV and recordkeeping requirements, and other compliance topics for private investment funds. He also recently contributed to *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and co-authored "The New AML Rules: Implications for Private Fund Managers" and "JOBS Act Update: CFTC Relief Removes Impediment to General Solicitation," which were published in *The Hedge Fund Journal*.

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Jenny advises hedge funds, private equity funds (including mezzanine and distressed funds), hybrid funds, funds of funds and investment advisers in connection with their structuring, formation and ongoing operational needs, general securities law matters, and regulatory and compliance issues. Her experience includes structuring and negotiating seed and strategic investments, advising investment managers regarding the structure and sale of their investment management businesses and the structure of their compensation arrangements, and representing investment managers in connection with managed accounts and single-investor funds.

Recognized by *The Legal 500 United States*, *Expert Guide to the World's Leading Banking*, *Finance and Transactional Law Lawyers* (Investment Funds) and *Expert Guide to the World's Leading Women in Business Law* (Investment Funds) and as an *IFLR 1000* "Rising Star" (Investment Funds), Jenny co-authored *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and recently presented at conferences on topics including compliance issues, hedge funds and management company structures, and considerations for emerging hedge fund managers.

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Seetha focuses on litigation, anti-money laundering and OFAC compliance, banking and securities enforcement, white collar criminal defense and regulatory investigations, and asset recovery for victims. As a former deputy chief in the Asset Forfeiture and Money Laundering Section (AFMLS), Criminal Division, U.S. Department of Justice, Seetha has expertise in matters that include allegations of violations of the Bank Secrecy Act (BSA), complex money laundering, economic sanctions, and civil and criminal forfeiture. During her tenure at AFMLS, she served as one of the first co-heads of the Money Laundering and Bank Integrity Unit, where she supervised a broad range of investigations and prosecutions of global financial institutions, including HSBC, MoneyGram, Standard Chartered Bank and ING, as well as emerging areas of money laundering and BSA enforcement such as online payment systems and virtual currencies. Seetha also worked closely with state and federal banking regulators and U.S. Attorneys' offices nationwide. Prior to her appointment at AFMLS, Seetha served as an Assistant U.S. Attorney for the Southern District of New York, where she worked in the Complex Frauds, Major Crimes and Asset Forfeiture units, investigating and prosecuting bank fraud, mail and wire fraud, tax fraud, money laundering, stolen art and cultural property, and civil and criminal forfeiture cases and appeals. She is also a former law clerk for the Honorable Richard J. Cardamone of the U.S. Court of Appeals for the Second Circuit.

The Legal 500 United States has recognized Seetha as a leading lawyer. She has counseled a range of companies on AML and OFAC compliance programs and procedures, including banks, broker-dealers, hedge funds, private equity firms, loan and finance companies, money services businesses, and online payment companies. She is also a frequent public speaker and has presented on topics that include enforcement trends in the financial services industry, emerging payment systems, effective AML programs, asset forfeiture and diversity of the white collar bar. Seetha is the co-author of "The New AML Rules: Implications for Private Fund Managers" in *The Hedge Fund Journal*, "Federal and State Regulators Target Compliance Officers — Parts I and II" in *The Banking Law Journal* and "The Interplay Between Forfeiture and Restitution in Complex Multi-Victim White Collar Cases" in the *Federal Sentencing Reporter*.

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Gary focuses on white-collar criminal defense and securities regulatory matters, complex commercial litigation, internal investigations, anti-money laundering issues, civil and criminal forfeiture proceedings and appellate litigation. He represents public companies, financial institutions, hedge funds, other entities and individuals as subjects, victims and witnesses in federal and state criminal investigations and regulatory investigations by the SEC, SROs and state attorneys general. He has conducted numerous internal investigations involving potential violations of the Foreign Corrupt Practices Act, financial statement fraud, money laundering and other matters, and advises companies on compliance with the FCPA and anti-money laundering and OFAC regulations. As a former Assistant U.S. Attorney and chief appellate attorney in the Southern District of New York, Gary investigated, prosecuted, tried and appealed numerous white collar criminal cases involving money laundering, fraudulent investment schemes, bank fraud, insider trading, art theft, illegal kickbacks, terrorist financing and other financial crimes. His civil litigation experience includes claims of fraud and breach of contract, securities class actions and derivative actions, contests over corporate control, and disputes arising from the sale of a business. He has handled more than 150 appeals in federal and state courts involving issues of both criminal law and procedure and complex commercial law. He has successfully argued 15 appeals in the U.S. Court of Appeals for the Second Circuit and most recently led the firm's pro bono representation in *Hurrell-Harring v. State of New York*, which resulted in a historic settlement that lays the foundation for statewide reform of New York's public defense system, and for which he received *New York Law Journal*'s 2015 Lawyers Who Lead by Example Award.

Gary is listed as a leading litigation attorney in *Benchmark Litigation: The Definitive Guide to America's Leading Litigation Firms & Attorneys*, *The Legal 500 United States* and *New York Super Lawyers*. He serves on the board of directors of The Legal Aid Society and the board of editors of the *Business Crimes Bulletin*. He regularly presents on FCPA, insider trading and trading compliance, risk management and crisis management issues at conferences and is an accomplished writer. He is the recipient of two Burton Awards for Achievement in Legal Writing — in 2008 for co-authoring "The Foreign Corrupt Practices Act: Recent Cases and Enforcement Trends," which appeared in the *Journal of Investment Compliance*, and in 2015 for authoring "Pension Forfeiture and Prosecutorial Policy-Making," which was originally published in the *N.Y.U. Journal of Legislation and Public Policy Quorum*. He is also the co-author of the "Scienter: Trading 'On the Basis Of'" chapter in the *Insider Trading Law and Compliance Answer Book* (Practising Law Institute) and of "The New AML Rules: Implications for Private Fund Managers" in *The Hedge Fund Journal*.

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The New Anti-Money Laundering Rule

I. Overview of the New Proposed Anti-Money Laundering ('AML') Rule for Registered Investment Advisers

A. Relevant Statutes and Regulations

1. The Money Laundering Control Act ("MLCA"), 18 U.S.C. §§ 1956 and 1957.

2. The Bank Secrecy Act ("BSA") of 1970, 31 U.S.C. §§ 5311 – 5330, as amended, including by the USA PATRIOT Act of 2001, and the BSA's implementing regulations, 31 C.F.R. Chapter X.

3. Economic sanctions enforced by the U.S. Department of Treasury's Office of Foreign Assets Control ("OFAC") prohibit U.S. citizens, businesses and financial institutions from engaging in transactions with persons designated on OFAC lists or located in prohibited jurisdictions (for example, individuals and entities on OFAC's Specially Designated Nationals and Blocked Persons List).

4. The Anti-Terrorism Act ("ATA"), 18 U.S.C. § 2333(a), provides for a private right of action for damages to any U.S. national "injured in his or her person, property, or business by reason of an act of international terrorism."

B. Background of the Proposed Rule

1. The BSA currently requires "financial institutions" to have effective AML compliance programs. "Financial institutions" currently include banks, broker-dealers, any entity required to register under the Commodity Exchange Act ("CEA") (including futures commission merchants ("FCMs"), introducing brokers in commodities ("IB-Cs"), commodity trading advisors ("CTAs"), and commodity pool operators ("CPOs")), mutual funds, operators of credit card systems, money services businesses, insurance companies, casinos, loan or finance companies, and dealers of precious metals, stones and jewels. The AML program rules instituted under the USA PATRIOT Act do not yet apply to private funds and investment advisers.

2. In 2002 and 2003, the Financial Crimes Enforcement Network ("FinCEN") proposed AML rules directed at investment advisers, unregistered investment companies and CTAs. Although the proposed rules were withdrawn in 2008, many investment advisers and private investment funds responded by developing and maintaining AML programs consistent with the proposed rules.

3. On Aug. 25, 2015, nearly seven years after FinCEN withdrew these earlier proposed AML rules, FinCEN issued for public comment a proposed rule requiring investment advisers registered with the SEC ("RIAs") to establish AML programs and report suspicious activity to FinCEN pursuant to the BSA (the "Proposed Rule").

4. The Proposed Rule will apply to "[a]ny person who is registered or required to register with the SEC" under Section 203 of the Investment Advisers Act of 1940, as amended (the "Advisers Act"). It thus will not apply to investment advisers that fall within an exemption from SEC registration, such as firms that rely on the exemption for venture capital fund advisers under Advisers Act Section 203(l), the exemption for private fund advisers managing less than $150 million in regulatory assets under management from a place of business in the United States under Section 203(m) or the exemption for foreign private advisers under Section 203(b)(3), family offices relying on Rule 202(a)(11)(G)-1, or CTAs whose business is not predominantly securities-related advice. However,

FinCEN cautions that "future rulemakings" may include other types of investment advisers found to present AML risks.

5. FinCEN is proposing to delegate to the SEC examination authority over RIAs for compliance with FinCEN's rules.

6. The public comment period has closed and the Proposed Rule will be subject to additional review and revision before it is finalized by FinCEN. The effective date is proposed as six months after the rule is published in the *Federal Register*. Accordingly, the earliest that RIAs might have to comply with the new rule is sometime in mid-2016.

C. AML Program Requirements

1. Under the Proposed Rule, an AML program must be approved in writing by the RIA's board of directors or its equivalent and include the following "four pillars":

    (a) Establish and Implement Policies, Procedures and Internal Controls to Ensure Ongoing Compliance: This means establishing and implementing written AML policies, procedures and internal controls. The AML program must be "reasonably designed to prevent the investment adviser from being used for money laundering or the financing of terrorist activities and to achieve and monitor compliance with" the BSA. Regulators want to see a "risk-based" approach in the design of the program.

    (b) Designation of a Qualified Person or Persons Responsible for Implementing and Monitoring the Operation and Internal Controls of the Program (the "AML officer"): The RIA must designate an individual or committee responsible for implementing and monitoring the operations and internal controls of the program, who is "knowledgeable and competent" regarding the regulatory requirements and the RIA's money laundering risks. Depending on the RIA's size and type of services, the AML officer need not be dedicated full time to BSA compliance, but "should be an officer of the investment adviser."

    (c) Ongoing Training for Appropriate Personnel: The nature, scope and frequency of training would be determined by the employees' responsibilities and the extent to which their functions bring them into contact with the BSA's requirements and possible money laundering. In addition to ensuring that such ongoing training complies with the Proposed Rule (e.g., tailoring training to the audience), the RIA should document its practices related to training so that it is prepared for an SEC examination with respect to compliance with the AML rules.

    (d) Independent Testing for Compliance: The Proposed Rule requires testing on a "periodic basis," explaining that the frequency of testing will depend upon the RIA's assessment of the risks posed. Such testing, designed to ensure that the program is functioning as intended, may be conducted by a qualified outside party. Alternatively, testing may be conducted by employees of the RIA, provided those employees are not involved in the operation or oversight of the AML program.

2. The government often evaluates AML programs according to their effectiveness. Recent enforcement actions demonstrate that deficiencies relating to any of these four AML pillars can result in liability under the BSA.[1]

3. The Proposed Rule will allow RIAs to delegate contractually the implementation and operation of aspects of its AML program. But importantly, the RIA, not the third-party administrator or other delegee, remains responsible for the effectiveness of the program as well as for ensuring access to documents and information by regulators like FinCEN and the SEC.

4. This means that to the extent that an RIA delegates AML functions to an agent or service provider, such as a third-party administrator, it still bears the burden of ensuring that the third-party administrator is effectively carrying out the "four pillars" of the AML program. The Proposed Rule specifically addresses the independent testing and training requirements in the context of service providers, noting that: (i) service providers may conduct independent testing so long as the employees who conduct the testing are not involved in the operation of the program and are knowledgeable of the BSA's requirements; and (ii) employees of an agent or third-party service provider must be trained in BSA requirements relevant to their functions and in recognizing possible signs of money laundering that could arise in the course of their duties.

5. The Proposed Rule does not, however, appear to allow RIAs to delegate the role of the AML officer to a third-party administrator; as noted above, it states that the person designated "should be an officer of the investment adviser."

D. Filing of Suspicious Activity Reports ('SARs')

1. Under the Proposed Rule, an RIA will be required to electronically file a SAR with FinCEN using FinCEN's BSA E-Filing system "no later than 30 calendar days after the date of the initial detection by the reporting investment adviser that may constitute a basis for filing a SAR." The purpose of a SAR is to report suspicious transactions that could suggest criminal activity, particularly money laundering and terrorist financing, but also other criminal activity such as fraud, to regulators and to law enforcement.

2. A SAR filing will be required for transactions involving at least $5,000 conducted or attempted by, at, or through the RIA where the RIA knows, suspects or has reason to suspect that the transaction:

   (a) Involves funds derived from illegal activity or is intended or conducted in order to hide or disguise funds or assets derived from illegal activity;

   (b) Is designed to evade the BSA or its implementing regulations;

   (c) Has no business or apparent lawful purpose or is not the sort of transaction the particular customer would normally be expected to engage in, and the RIA knows of no reasonable explanation for the transaction after examining the available facts; or

   (d) Involves use of the RIA to facilitate criminal activity.

3. In issuing the Proposed Rule, FinCEN offers several examples of money-laundering "red flags" that might qualify as SAR-worthy events for an investment adviser. These include:

[1] *See, e.g.,* Oppenheimer & Co., Inc., FinCEN Matter No. 2015-01 (Jan. 27, 2015); Halcyon Cabot Partners, Ltd., FINRA Case No. 2012033877802 (Oct. 6, 2015); Global Strategic Investments, LLC, FINRA Case No. 2011025676501 (April 27, 2015); and Cobra Trading, Inc., FINRA Case No. 2013035340001 (Feb. 17, 2015).

(a) A client who exhibits unusual concern regarding the adviser's compliance with government reporting requirements or is reluctant to provide information on its business activities.

(b) A client who appears to be acting as the agent for another entity declines, evades or is reluctant to provide responses to questions about that entity.

(c) A client's account has a pattern of inexplicable or unusual withdrawals inconsistent with the client's investment objectives.

(d) A client's request that a transaction be processed in a manner to avoid the adviser's normal documentation requirements.

(e) A client exhibits a total lack of concern regarding performance returns or risk.

4. RIAs must maintain the confidentiality of a SAR. Disclosing a SAR, or even information that would reveal the existence of a SAR, can constitute a crime under federal law. The disclosure restrictions apply not only to parties implicated in the suspicious activity, but also to other parties, and even apply to demands for documents made in the course of civil litigation.

5. The Proposed Rule also allows RIAs to delegate their SAR reporting responsibilities to a third-party service provider. Here again, the RIA remains responsible for its compliance with the SAR reporting requirement, including the requirement to maintain SAR confidentiality.

6. In addition to filing a SAR, the Proposed Rule requires RIAs to immediately notify an appropriate law enforcement authority by telephone in situations "involving violations that require immediate attention," such as suspected terrorist financing or "ongoing" money-laundering schemes.

7. SAR supporting documentation must be made available to FinCEN, the SEC and any law enforcement agency, and must be maintained by the RIA for a period of five years from the date of filing the SAR.

8. The Proposed Rule acknowledges that in some cases, an RIA and another BSA-covered institution, such as a bank, may file a SAR on the same suspicious transaction, and in such cases will only require that one institution file a SAR. In these cases, the facts, transactions and documents underlying a SAR may be shared for the preparation of a joint SAR. But this too requires careful coordination and planning, given the requirements of SAR confidentiality.

E. Record-Keeping and Travel Rules

1. The Proposed Rule will also subject RIAs to the BSA's Record-Keeping and Travel Rules, which impose several requirements on financial institutions with regard to funds transfers and certain other transactions.

2. First, financial institutions must obtain and retain records for transmittals of funds in excess of $3,000. The information to be obtained and retained includes the name and address of the transmittor, the payment instructions received from the transmittor, and information provided about the recipient. The record retention period is five years, which is consistent with most RIAs' existing record retention practices. Records must be filed or stored in such a way as to be accessible within a reasonable period of time, and retrievable by the transmittor's financial institution by reference to the name of the transmittor.

3. Second, financial institutions must ensure that certain information pertaining to the transmittal of funds in excess of $3,000 “travel” with the transmittal to the next financial institution in the payment chain. This applies when the financial institution is transmitting funds or receiving funds as an intermediary financial institution to be transmitted to another institution. The information that must be made part of the chain includes the name, address and account number of the transmittor and information provided about the recipient. The Proposed Rule notes that investment advisers would fall within an existing exception to the Record-Keeping and Travel Rules that is designed to exclude transmittals of funds in which the transmittor, originator, recipient or beneficiary are certain categories of financial institutions, including banks, brokers or dealers in securities, and mutual funds. However, this exception applies only where the financial institution is the interested party in the transaction, not where the financial institution is merely sending or receiving funds on behalf of another party.

4. Third, financial institutions are required under the Record-Keeping and Travel Rules to create and retain records for extensions of credit and cross-border transfers of funds, currency, monetary instruments, checks and investment securities, where the transactions exceed $10,000.

F. Filing of Currency Transaction Reports (‘CTRs’)

1. The Proposed Rule will require RIAs to file CTRs for transactions involving more than $10,000 in currency.

2. This change is unlikely to have a substantial impact on RIAs, as RIAs are already required to report such transactions on a different form, known as a Form 8300, and most RIAs do not deal in cash (and may have policies prohibiting cash transactions).

G. Section 314 of USA PATRIOT Act

1. Under the Proposed Rule, RIAs will be subject to government requests for information under Section 314(a). Section 314(a) authorizes law enforcement agencies to request, through FinCEN, that financial institutions search their records to determine whether they have maintained an account or conducted a transaction with a person that law enforcement has certified is suspected of engaging in terrorist activity or money laundering. Compliance with a Section 314(a) request is not voluntary; financial institutions must provide identifying information for the accountholder or transaction in question. Furthermore, financial institutions must maintain adequate procedures to protect the security and confidentiality of Section 314(a) requests.

2. The Proposed Rule will also expand *voluntary* information-sharing under Section 314(b) of the USA PATRIOT Act to include RIAs. Section 314(b) allows (and in fact encourages) financial institutions and some related entities in the United States to share information for the purpose of identifying and reporting money laundering or terrorist activity, with specific protection from civil liability. Although there are requirements that an RIA must follow to take advantage of Section 314(b)’s safe harbor, it provides a potentially valuable tool for investment advisers to gather from other financial institutions information on investors and other relevant parties where needed.

H. Implementation of a Customer Identification Program (‘CIP’)

1. At this time the Proposed Rule does not require RIAs to establish a CIP pursuant to Section 326 of the USA PATRIOT Act. The Proposed Rule states that FinCEN will address CIP requirements for RIAs via a joint rulemaking effort with the SEC.

2. On July 30, 2014, FinCEN proposed a new "customer due diligence" ("CDD") rule that goes beyond the customer identification program currently required of financial institutions under the BSA. The new rule requires banks, brokers or dealers in securities, mutual funds, FCMs and IB-Cs to determine the *beneficial owners* of their legal entity customers. While there are some legal entity customers exempt from the rule, for which no beneficial owner needs to be identified, the exemption *does not apply to private investment funds*. This means that under the proposed CDD rule, private investment funds and other non-exempt entities would need to provide beneficial ownership information to financial institutions.

II. Some Practical Implications of the Proposed Rule for RIAs

If the Proposed Rule is adopted in its current form, RIAs will need to consider taking the following actions:

A. Review of Administration Agreement: To the extent an RIA delegates to a third-party administrator AML functions, the RIA should review and revise, as necessary, the administration agreement. If the administration agreement currently includes only the fund, and not the RIA, as a party to the agreement, consider amending it to include the RIA as a party to the agreement. Also consider revising the administration agreement to include any increase or change in the administrator's role with respect to AML functions on behalf of the RIA and the funds and to permit the RIA to inspect, review or otherwise oversee the operations of the administrator with respect to its AML functions and to obtain access to relevant records of the administrator.

B. Offering Memoranda: Offering memoranda, or private placement memoranda, will likely need to be revised to reflect certain changes in the rules and procedures in light of the new rules. Currently, many offering memoranda discuss the fund's or the administrator's AML policies or procedures under applicable non-U.S. laws. However, such offering documents should be revised to reflect that the RIA is also subject to AML laws and regulations in the United States and has implemented its own policies and procedures to comply with such requirements. The offering memorandum should also be updated to disclose the requirement for SAR reporting, which is a new requirement under the Proposed Rule.

C. Subscription Agreements: Subscription agreements, or subscription documents, may need to be revised if the RIA adopts an AML program that requires fund investors to provide additional or otherwise different documentation or information than what the RIA currently requests from investors in the subscription agreements.

D. Expenses: It is expected that there will be an increase in expenses relating to AML compliance. The expense language in the offering documents and governing documents of the fund (e.g., the partnership agreement) should align with the RIA's actual expense-allocation practices. While most RIAs bear their own internal compliance-related expenses, the fees and expenses of the administrator are typically borne by funds. RIAs will need to carefully consider additional AML compliance-related expenses and whether those are management company or fund expenses.

III. Summary of Comments to FinCEN on the Proposed Rule

Below is a chart that highlights certain of the comments made regarding the Proposed Rule in some (but not all) of the comment letters submitted to FinCEN. All of the comment letters on the Proposed Rule are available online.[2]

No.	Party	Comments
1.	Managed Funds Association (MFA)	• Excluding subadvisers from the definition of "investment adviser" • Providing guidance on delegation of AML program; permitting the delegation of the AML program, SAR reporting and Section 314 requests to offshore administrators • Allowing RIAs to take into consideration the AML procedures of financial institutions or other investor intermediaries when assessing risk • Clarifying that the intent of the Proposed Rule, including SAR reporting, is to cover activities involving investors, and not other aspects of an RIA's operations, such as investment activity • Clarifying that FinCEN does not expect RIAs to incorporate existing non-AML procedures relating to securities laws into their AML programs or SAR monitoring systems • Clarifying that RIAs are not required to reassess the due diligence previously conducted on existing investors • Permitting appropriately knowledgeable and responsible personnel to be designated as an AML officer, even if not an officer of the RIA • Clarifying that, if a committee is designated, not all members of the committee need to be employees of the RIA • Permitting senior management to approve the RIA's AML program, and not requiring written board approval • Permitting SAR sharing within an RIA's corporate organizational structure and between an RIA and the directors and officers of the private funds managed by the RIA and the funds' administrator • Excluding RIAs from the BSA's Record-keeping and Travel rules • Using CTRs for large currency transactions • Clarifying applicability of certain sections of the USA PATRIOT Act • Requiring the SEC to publicly release a copy of its relevant AML examination manual
2.	Securities Industry and Financial Markets Association (SIFMA)	• Limiting scope of the AML rule to RIAs in the United States and relating to their U.S. activity • Excluding from the AML program requirement certain types of investors, advisory activity or advisory relationship • Focusing on the risks posed by direct clients as opposed to certain pooled investment vehicles where investor information is typically limited • Clarifying that risk assessments may take different forms depending on the RIA's business • Accommodating different organizational structures (e.g., allowing for AML program approval by senior management; removing requirement that AML officer must be a corporate officer; allowing AML officer to be an employee of an affiliate of the RIA) • Allowing RIAs to share SAR filings within their corporate organizational structures

[2] Comment letters are available via the *Federal Register* at https://www.federalregister.gov/articles/2015/09/01/2015-21318/anti-money-laundering-program-and-suspicious-activity-report-filing-requirements-for-registered.

No.	Party	Comments
3.	Financial Services Roundtable (FSR)	• Excluding from the AML program (and other attendant) requirements certain types of advisers or advisory activity • Allowing RIAs to share SAR filings within a consolidated financial organization • Removing requirement that AML officer must be a corporate officer • Allowing for reliance and delegation of AML diligence and monitoring between primary and sub-advisers
4.	Investment Adviser Association (IAA)	• Excluding certain types of advisory business from adopting AML obligations • Addressing practical burdens (e.g., allowing for AML program approval by senior management; removing requirement that AML officer must be a corporate officer) • Providing flexibility in the independent testing requirement and permitting small advisers to employ an internal testing program that may include employees involved in the AML program • Confirming that the obligation to assess AML risks relating to the underlying investors of a private fund applies only when the RIA is the primary adviser to that private fund and has access to information about the private fund's underlying investors • Allowing RIAs to share SAR filings within their corporate organizational structures • Permitting RIAs to coordinate any SAR reporting obligations with their qualified custodians • Reassessing costs of the proposal, particularly to smaller advisers
5.	Investment Company Institute (ICI)	• Rescinding the BSA regulations applicable to mutual funds or, alternatively, exempting mutual funds from an RIA's AML program • Exempting sub-advisory services from an RIA's AML program • Confirming that RIAs may be unable to "look through" to investors in funds in certain situations, including where privacy laws and other local requirements may prevent an RIA from obtaining information about investors • Not applying the rule to non-U.S. RIAs because an RIA's obligations under the BSA may not be consistent with local privacy rules and other requirements • Allowing RIAs to share SAR filings within their corporate organizational structures • Confirming that an RIA that is dually registered as a broker-dealer, or is affiliated with a bank, is expected to comply only with the BSA rules applicable to RIAs with respect to its investment advisory activities • Excluding from the final rule advisory services provided to employees' securities companies
6.	Alternative Investment Management Association (AIMA)	• Limiting rule to RIAs who are U.S.-domiciled or not already subject to adequate AML rules in their own jurisdiction • Confirming that delegations of duties under the AML program could be made to entities that are not U.S. financial institutions and can be made to non-U.S. entities (e.g., a third-party administrator who is not a financial institution)
7.	The Financial Services Institute (FSI)	• Authorizing RIAs to share SARs within their corporate organizations • Clarifying that the SAR obligation rests with the financial institution that identifies the suspicious activity where an individual is licensed with both an RIA and a broker-dealer • Exempting RIAs from the requirements of the Record-Keeping and Travel Rules so long as their custodian agrees to ensure compliance with these rules for the RIA's customers

No.	Party	Comments
8.	Private Equity Growth Capital Council (PEGCC)	• Excluding from the AML program requirements private equity funds and RIAs that manage only such funds • Providing clear guidance regarding: (i) which funds and other advisory clients present low risks; and (ii) the nature of the AML program requirements that apply in the case of low-risk products and clients • Clarifying that activities outside the scope of advisory services do not trigger requirements, including SAR requirements, under the AML rules
9.	Wells Fargo & Company (Wells Fargo)	• Excluding from the AML program requirements advisory services that RIAs provide to registered open-end and closed-end funds • Excluding from the AML program requirements advisory services that RIAs provide to wrap fee programs and primary advisers • Excluding foreign advisers that have no place of business in the United States from the definition of "financial institution" under the BSA • Permitting RIAs to share SARs within their corporate organizational structures
10.	American Bankers Association (ABA)	• Emphasizing that the AML programs that RIAs are expected to adopt should be commensurate with their size, customer base and business operations
11.	TIAA-CREF	• Excluding certain low-risk activities and related risk assessments • Applying AML program requirements only to asset management activities and limited aspects of the provision of individualized financial advice • Excluding advisory services to clients with trading or custodial accounts at broker-dealers or banks • Excluding advisory services to mutual fund clients • Excluding adviser-initiated investment activity and encouraging voluntary SAR filing (not requiring mandatory SAR filing) • Excluding subadvisory services • Permitting SAR sharing within an RIA's corporate organizational structure • Applying only to advisory services • Noting that planned giving programs pose low AML risks • Clarifying that a dually registered entity's broker-dealer AML policies and practices are conclusively presumed to be sufficient for the entity's overall AML program requirements • Clarifying that an adviser may safely rely on the AML program activities conducted by a broker-dealer or bank through which client transactions related to a real estate fund are effected
12.	T. Rowe Price Associates Inc.	• Excluding non-U.S. advisers from the AML requirements • Excluding an RIA: (i) acting as an adviser or sub-adviser to a mutual fund; or (ii) serving in a relationship not involving the discretionary management of client assets • Limiting a sub-adviser's responsibilities to solely relate to the party that hired the sub-adviser so that there will be no obligation to "look through" to the vehicle's investors • Authorizing the sharing of SARs within an RIA's organizational structure

Trading Compliance: Managing Regulatory Risk

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David focuses his practice on matters related to fiduciary responsibility, the Employee Retirement Income Security Act of 1974 (ERISA) and qualified plans. Prior to joining Schulte Roth & Zabel, he held positions in both the private sector (as vice president and assistant general counsel of a major investment firm) and government service (with the Department of Labor Employee Benefits Security Administration's Divisions of Regulatory Coordination and Exemptions).

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Brian advises hedge fund and private equity fund managers and commodity pool operators on regulatory, compliance and operational matters, including registration and disclosure obligations, trading issues, advertising and marketing, and the establishment of compliance programs. Having spent nearly a decade serving in-house as general counsel and chief compliance officer at several prominent hedge fund management firms, he is well-versed in a wide range of legal and business challenges facing investment advisers, commodity pool operators and commodity trading advisors and has extensive experience designing and improving compliance processes and organizational systems. Brian has represented clients in the context of regulatory examinations, trading inquiries and enforcement actions, and in seeking no-action or similar relief in the United States, the United Kingdom and Asia.

Brian is well known for his thought leadership in the regulatory and compliance area as it affects alternative investment funds and is a key part of Schulte Roth & Zabel's educational outreach. In addition to hosting SRZ webinars, participating in firm-sponsored seminars and workshops, and authoring SRZ alerts and white papers, he recently published "Q&A with Brian T. Daly: SRZ's Systematic and Quantitative Strategies Practice" in *The Hedge Fund Journal* and "Securities, Futures Regulators Increase Scrutiny, Expectations on Cybersecurity" in *Bloomberg Brief — Financial Regulation*. His recent speaking engagements addressed topics including how U.K. fund managers registered as CPOs or CTAs should prepare for NFA examinations, and hedge fund and management company structures. Brian also teaches legal ethics at Yale Law School, focusing on the challenges faced by in-house counsel. He is a chair of the Steering Committee for the Managed Funds Association's CTA/CPO Forum and a member of the CFTC Working Group for the Alternative Investment Management Association and of the New York City Bar Association's Private Investment Funds Committee. He formerly served as co-chair of the MFA's General Counsel Forum, its CTA, CPO & Futures Committee, and as a steering committee member of its Investment Advisory Committee.

Brian received his J.D., with distinction, from Stanford Law School, his M.A. from the University of Hawaii, and his B.A., *magna cum laude*, from Catholic University of America.

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Ele practices in the areas of securities law, shareholder activism, mergers and acquisitions, and regulatory compliance. He serves as co-chair of Schulte Roth & Zabel's global Shareholder Activism Group, assisting activists and companies with matters ranging from corporate governance and control to proxy contests and defensive strategies. Ele has been well known for his expertise since the 1990s for the development and implementation of alternative investment structures for private equity investments and, specifically, the structuring and negotiating of private investments in public equity, or PIPEs, and related products including registered direct offerings, convertible 144A offerings, reverse mergers, equity lines and SPACs. He works on numerous activist campaigns and PIPE or PIPE market-related transactions every year for some of the largest private investment groups and investment banks in the United States and abroad. In addition, he advises on initial public offerings and secondary offerings, venture capital financing, and indenture defaults and interpretation, and he counsels clients in the regulatory areas of short selling, tender offers and short tender offers, Sections 13 and 16, Rules 144 and 144A, insider trading and Regulation M/Rule 105.

Ele is listed in *The Legal 500 United States*, *New York Super Lawyers*, its New York Metro Top 100 list and *Super Lawyers Business Edition* (a national listing selected from the *Super Lawyers* regional awards), and he was named to *The DealFlow Power 20* list for being a top influencer in the small-cap financing market. Ele's extensive PIPEs experience is reflected in his contribution to *PIPEs: A Guide to Private Investments in Public Equity* (Bloomberg Press), a leading treatise in the PIPEs arena. He also contributed to *Shareholder Activism Insight 2014* (SRZ in association with Mergermarket) and authored the "Transaction Reporting" chapter in *Investment Management: Law and Practice* (Oxford University Press), covering Schedules 13D and 13G and Section 16 filings. In addition, he has become a leading source for business journalists and business news organizations, and a much sought-after speaker by sponsors of shareholder activism, PIPEs, SPACs and regulatory conferences. Ele has served as a moderator and speaker at numerous conferences and events addressing shareholder activism, PIPEs, M&A deals, the capital markets and other topics of interest to the alternative investment industry.

Ele received his J.D. from Yale Law School and his B.S., *summa cum laude*, from Brooklyn College, CUNY.

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Howard Schiffman

Howard is co-chair of Schulte Roth & Zabel's Litigation Group. Nationally known in the area of securities litigation and regulatory developments, his practice focuses on investigations and enforcement proceedings brought by various exchanges and government agencies, including the SEC, the DOJ and FINRA, as well as a diverse array of civil litigation, including securities class actions and arbitrations. A corporate problem solver, Howard is as adept at dispute containment and resolution as he is at arguing to a jury. He counsels clients, including major financial institutions and investment banks, leading Nasdaq market-makers, institutional and retail brokerage firms and their registered representatives, trade execution and clearing firms, prime brokers, national accounting firms, hedge funds, and public and private companies and their senior officers in risk analysis and litigation avoidance. With his extensive trial experience and solid record of success in numerous SEC enforcement actions, SRO proceedings and FINRA arbitrations, Howard has the confidence to take a case to trial when necessary. He recently represented Goldman Sachs in a FINRA dispute resolution arbitration brought by hedge fund Walrus Master Fund Limited and Adam D. Sender that requested more than $60 million in damages and alleged that claimants suffered losses resulting from liquidating securities positions to meet risk calls during the October 2008 financial crisis. Howard achieved an arbitration award denying all of the claims and assessing forum fees against the claimants, handing Goldman Sachs a resounding victory. He also prevailed in a written opinion from the Grand Court of the Cayman Islands by overseeing the successful defense at trial against a petition for the winding up of Harbinger Class PE Holdings (Cayman) Limited in which shareholders argued that the fund's purpose could no longer be achieved. He has obtained victories in other significant matters, including prevailing in a price adjustment case involving the dispute of several hundred million dollars for a portfolio of real estate mortgages, and he represented the former CEO of the largest Nasdaq market-making firm, Knight Securities, in a federal court action brought by the SEC. After a 14-day bench trial, all parties were completely cleared of wrongdoing. Howard began his career as a trial attorney with the SEC Division of Enforcement. In private practice for more than 30 years, he has long been at the forefront of securities litigation and regulatory developments, including his current representation of hedge funds, leading prime brokers and clearance firms in regulatory and civil litigation.

Howard was included in *Washingtonian* magazine's "800 Top Lawyers" listing (a ranking of "Washington's best — the top one percent") and in *Washington DC Super Lawyers*, and he has been recognized by *Chambers USA*, *The Legal 500 United States* and *Benchmark Litigation: The Definitive Guide to America's Leading Litigation Firms and Attorneys*. He is a member of American Bar Association sections on Litigation, Corporation, Finance and Securities Law and a fellow of the Litigation Counsel of America, and a director and former president of the Association of Securities and Exchange Commission Alumni Inc. He is the author of the "Tipper and Tippee Liability" chapter in the *Insider Trading Law and Compliance Answer Book* (Practising Law Institute) and most recently presented on ethical issues for general counsels and chief compliance officers.

Howard received his J.D., *cum laude*, from Fordham University School of Law and his B.A., *cum laude*, from Colgate University.

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Craig co-heads Schulte Roth & Zabel's Structured Finance & Derivatives Group. His practice focuses on swaps and other derivative products, including credit- and fund-linked derivatives, prime brokerage and customer trading agreements, and structured finance and asset-backed transactions. He represents issuers, underwriters, collateral managers and portfolio purchasers in public and private structured financings, including collateralized loan obligations (CLOs).

Chambers USA has noted that satisfied clients have praised Craig for his "very broad knowledge of the markets" and for being "incredibly responsive and helpful in thinking through issues." *Chambers* also notes, "He is known for his work in derivative products, representing issuers, underwriters and portfolio purchasers in CLOs. Peers find his work in structured products and derivatives impressive." *The Legal 500 United States* has noted that Craig is "recognized for his thought leadership on regulatory issues affecting both the securitization and derivatives markets." He is also recognized as a leader in his field by *Chambers Global* and *Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers* (Structured Finance and Securitization). Craig is a member of the American Bar Association, the New York City Bar Association, the New York State Bar Association, the Loan Syndications and Trading Association, the International Swaps and Derivatives Association and the Structured Finance Industry Group. He is a much sought-after speaker for hedge fund industry conferences and webinars and the author of numerous articles on advanced financial products. He recently co-authored "New Margin Requirements for Uncleared Swaps" in *Harvard Business Law Review Online* and "CLOs and Risk Retention" for *The International Comparative Legal Guide to: Securitisation 2015*, and he spoke on how alternative asset managers and banks work together post-Basel III and on the challenges of launching CLO platforms.

Craig earned his J.D., *cum laude*, from the University of Pennsylvania Law School and his undergraduate degree, *cum laude*, from Colgate University.

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Steven's practice focuses on advising on the establishment and operation of hedge funds in the United Kingdom, Europe and a variety of offshore jurisdictions, and on the structuring and operation of hedge fund management groups, including LLP agreements, and on seed-capital arrangements. Steven also advises on the establishment and listing of closed-end public funds and U.K. onshore funds.

Steven has been recognized by *Chambers UK*, *Expert Guide to the Best of the Best*, *Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers*, *IFLR1000*, *The Legal 500 United Kingdom* and *Who's Who Legal: The International Who's Who of Private Funds Lawyers* for his preeminence in the investment funds sector, with interviewees describing him as "top notch" and "fantastic." He is "one of the leading partners in investment funds in Europe," according to a client quoted in *Chambers UK*, who adds that "with Steven as counsel, it is easy to navigate the post-AIFMD regulatory landscape." Steven is a member of the International Bar Association and a member of the Collective Investment Schemes Sub-Committee of The Law Society, and is co-chair of the Sound Practices Committee of the Alternative Investment Management Association. He also chaired the AIMA working group which updated the *Fund Directors' Guide*. Steven is the co-author of "AIFMD Update: ESMA Advice on Extension of Marketing Passport Published" in *The Hedge Fund Journal* and "Marketing Alternative Funds in Europe: A Changed Landscape" in *Risk & Compliance Magazine*. He most recently addressed topics at conferences and seminars including "hot topics" for U.K. hedge fund managers, the evolution of fund governance and the marketing of private funds.

Steven graduated with an honors degree in law from Cardiff University and attended the College of Law.

Trading Compliance: Managing Regulatory Risk

I. Rule 105 of Regulation M and Regulation SHO

A. Generally: What Is Rule 105?

Rule 105 makes it unlawful for any person to "sell short" during the "Rule 105 restricted period" an equity security that is being offered for cash pursuant to a registration statement in a firm commitment underwritten offering and purchase the offered securities.

B. Why Is Rule 105 Significant, and Why Does Preparation Matter?

1. Rule 105 enforcement rose sharply in 2010.

2. Rule 105 is a prophylactic rule, and therefore, 105 actions are easy to bring — if there is a violation, there is no legal defense. There is no requirement of intent to manipulate the price of the security.

3. Rule 105 is not intended to catch only systematic "scams" — even a single violation can lead to charges.

4. Charges can be based on even trivial profits, but penalties, in addition to disgorgement of profits, can constitute a significant percentage of the overall resolution.

5. Rule 105 violations are also subject to various reporting requirements (e.g., 13D, ADV) (but note that a Rule 105 violation does not automatically trigger the "bad actor" rule under Regulation D).

6. Rule 105 violations fall under the category of "market manipulation" and can also lead to censure, suspension or a lifetime ban of being associated with an investment adviser or broker-dealer, all of which can cause investor concern and affect a firm's ability to keep and/or raise capital.

C. How to Avoid a Rule 105 Violation: A Checklist of Rule 105 Provisions

1. What types of offerings does Rule 105 apply to? Firm commitment underwritten offerings of equity securities:

(a) How do you distinguish between a firm commitment offering and best efforts offering?

(i) Firm Commitment Underwritten Offering: A firm commitment underwritten offering is generally one where one or more investment banks agree to act as an underwriter and are thereby obligated to purchase a fixed number of securities from the issuer, which they resell to the public.

(ii) Best Efforts Offering: An investment bank agrees to act as placement agent to do its best to sell the offering to the public but does not buy the securities from the issuer and does not guarantee that it will sell any amount of the securities.

(b) What is the subject equity security?

(i) Rule 105 only applies to equity securities.

(ii) An offering of non-convertible debt would not fall under the rule. An offering of convertible debt would fall under the rule, as convertible debt is itself an equity security. However, the rule prohibits only the selling short of the "security that is the subject" of the offering; therefore a short sale of the underlying common stock would not prohibit participation in an offering of the convertible debt. However, the general anti-fraud and anti-manipulation provisions of the federal securities laws still apply.

(iii) Options and other derivatives are not considered equity securities under the rule. However, again, the SEC has made clear that the anti-fraud and anti-manipulation provisions of the federal securities laws still apply in this context.

(c) Global Offerings and Short Sales Abroad

(i) A person cannot participate in an offering in the United States if he or she sold the subject securities short on a foreign exchange during the Rule 105 restricted period.

(ii) In an entirely foreign distribution of a security that has no market in the United States, but whose reference security does have a market in the United States, the foreign distribution is not subject to Regulation M. For example, Rule 105 does not prohibit a short sale of common stock in a foreign offering during the Rule 105 restricted period and participation in an offering for ADRs because they are not the same subject security. However, the general anti-fraud and anti-manipulation provisions of the federal securities laws may apply to any transaction effected in the United States. Be especially careful here because the ADR can essentially be seen as a re-packaging of the common stock.

2. Rule 105 Restricted Period: The shorter of the period: (i) beginning five business days before the pricing of the offered securities and ending at pricing; and (ii) beginning at the initial filing of the registration statement and ending at pricing.

(a) How is the five-business-day period calculated?

(i) "Business day" refers to a 24-hour period determined with reference to the principal market for the securities to be distributed, and that includes a complete trading session for that market.

(ii) If pricing occurs after the principal market closes, then the day of pricing is included in the five-business-day period. For example, if pricing occurs on a Thursday after the principal market closes, then the restricted period would begin at the close of trading on the previous Thursday and end at pricing on the following Thursday.

(iii) Problems with Holidays: If the principal market is closed for a holiday, then such date will not count as a business day within the five-business-day period.

(b) How is the period beginning from the initial filing of the registration statement calculated?

(i) The period begins with the issuer's initial filing of a registration statement for secondary offerings. Oftentimes this is done well in advance (sometimes years) before the secondary offering at hand. But sometimes it is done by WKSIs (because they can file an automatic shelf registration statement) right before the offering, in which case, this period may be shorter than the five-business-day period.

(ii) A prospectus supplement containing the specific information with respect to the offering might be filed right before the offering. This is not the initial registration statement.

3. What is a short sale?

(a) Definition Under Section 200(a) of Regulation SHO: "The term short sale shall mean any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller."

(b) When does a person own a security?

(i) The person has title to it.

(ii) The person has purchased it pursuant to an unconditional contract, binding on both parties, to purchase it but has not yet received it.

(iii) The person owns a security convertible into or exchangeable for it and has tendered such security for conversion or exchange.

(iv) The person has an option to purchase it and has exercised the option.

II. Section 13(d) and Section 16 Reporting Requirements Under the Securities Exchange Act of 1934 (the 'Exchange Act')

A. Section 13(d) Reporting Requirement Trigger

1. Upon becoming a greater than 5-percent "beneficial owner" of any voting, equity security registered under the Exchange Act ("Subject Securities")

(a) A beneficial owner of a security includes any person who, *directly or indirectly*, through any contract, arrangement, understanding, relationship or otherwise has or shares *voting power* and/or *investment power* with respect to such security. An investment manager's beneficial ownership should be calculated based on the aggregate positions of all entities it manages that are not disaggregated from each other for purposes of Section 13(d) and Section 16 reporting.

(i) Voting power includes the power to vote, or to direct the voting of, a security.

(ii) Investment power includes the power to dispose, or the power to direct the disposition, of a security.

(b) Rule 13d-3(d)(1)(i) provides that a person is deemed to be the beneficial owner of a security if that person has the right to acquire beneficial ownership of that security within 60 days.[1]

(c) Rule 13d-5(b)(1) provides that when two or more persons agree (whether formal or informal, orally or in writing) to act together for the purpose of acquiring, holding, voting or disposing

[1] However, non-passive holdings confer beneficial ownership for a right to acquire at any time — even after 60 days. This important exception to the 60-day rule provides that any person who has a right to acquire beneficial ownership of a security with the purpose or effect of changing or influencing control of the issuer, or in connection with or as a participant in any transaction having such purpose or effect, is deemed to be a beneficial owner of the security immediately upon acquiring the right to acquire the security regardless of whether that right cannot be exercised within 60 days. Nonetheless, a person does not beneficially own subject securities underlying a derivative security if the right to acquire the underlying subject security is subject to material contingencies outside the control of such person that cannot be waived (e.g., the requirement to obtain a governmental approval or the effectiveness of a registration statement). Such a right does not create beneficial ownership until the contingency is met even where these material contingencies could be met within the 60-day period.

of subject securities, all members of the group formed thereby will be deemed to have beneficial ownership of all subject securities beneficially owned by the other members of the group.

(i) To be a member of a group a person first must be the beneficial owner of subject securities.

(ii) Private investment funds, mutual funds, private equity funds and similar investment vehicles ("Funds") with a common investment manager may be deemed to be a group if the investment manager(s) make similar acquisitions and dispositions of subject securities on behalf of the Funds at the same time or there is a common plan or goal among the investment manager(s) for the Funds. Depending on the facts, it is even possible for a managed account client to be deemed to be a group with the investment manager managing its account. Relevant facts to consider include transparency of trading data or other sharing of information related to a subject security and whether the client trades the subject security outside of the account in a manner that is similar to the trading done in the account.

(iii) If considered a group, the subject securities held by the Funds and/or clients must be aggregated when determining whether the 5-percent threshold has been crossed.[2]

(iv) A group can also be formed with unaffiliated entities or persons if an agreement as to the acquisition, holding, voting or disposition of subject securities exists.

B. Type of Filing Required: Schedule 13D or the Short Form Schedule 13G?

1. Section 13(d) of the Exchange Act requires a beneficial owner that acquires more than 5 percent of a class of subject securities to file on Schedule 13D unless eligible to file on Schedule 13G.

(a) The initial Schedule 13D filing must be made within 10 calendar days of crossing 5 percent.

(b) Amendments must be made "promptly"[3] upon any material change in the information previously reported.

(i) An acquisition or disposition of 1 percent or more of the class of securities is deemed to be a material change requiring an amendment.

(ii) Another common amendment trigger is any material change to a filer's plans or proposals with respect to the issuer (under Item 4 of Schedule 13D).

2. Eligibility to File on Schedule 13G

(a) 13d-1(b) Qualified Institutional Investors: Certain institutional investors (e.g., registered investment advisers, registered investment companies and registered brokers or dealers) may file on Schedule 13G as long as they have acquired the subject securities in the ordinary course

[2] The common investment manager(s) would be deemed to beneficially own the aggregate number of subject securities held across the Funds/client accounts regardless of whether the Funds and/or accounts are deemed to be a group. So, it is the aggregate ownership across the Funds and accounts that would trigger a filing and be reported in either case. Accordingly, the Funds and/or accounts being deemed to be a group is of little consequence in terms of triggering a filing requirement. However, the finding of group status could subject the Funds and accounts to individual reporting and Section 16's short-swing profit rules and require accelerated Schedule 13G reporting under Rule 13d-1(c), as discussed below.

[3] "Promptly" is not defined in the rules but has generally been interpreted by courts to mean not more than two business days.

of business and not with the purpose nor with the effect of changing or influencing the control of the issuer.

(i) The initial Schedule 13G is required to be filed within 45 days after the end of the calendar year if the beneficial ownership of the reporting person(s) exceeds 5 percent as of Dec. 31; provided, that, if the reporting person(s) beneficial ownership exceeds 10 percent prior to the end of the calendar year, the reporting person's or persons' initial Schedule 13G must be filed within 10 days after the end of the first month in which the reporting person's or persons' beneficial ownership exceeds 10 percent on the last day of the month.

(ii) Amendments are required:

(1) Within 45 days of the end of the calendar year if, as of Dec. 31, there is any change in the information previously reported (unless the only change is a change in the percentage beneficially owned and such change is a result of a change in the number of shares of the class outstanding);

(2) Within 10 calendar days after the end of any month in which beneficial ownership exceeds 10 percent as of the end of the month; and

(3) Once over 10 percent, within 10 calendar days of the end of any month in which beneficial ownership increases or decreases by more than 5 percent as of the end of the month.

(b) 13d-1(c) Passive Investors: Investors that are not one of the types of institutional investors permitted to file under Rule 13d-1(b) may file under Rule 13d-1(c) as long as they have not acquired the subject securities with the purpose, or with the effect of, changing or influencing control of the issuer *and* their beneficial ownership does not constitute 20 percent or more of the class of subject securities.

(i) The initial Schedule 13G is required within 10 days of crossing 5-percent beneficial ownership.

(ii) Amendments are required:

(1) Within 45 days of the end of the calendar year if, as of Dec. 31, there is any change in the information previously reported (unless the only change is a change in the percentage beneficially owned and such change is a result of a change in the number of shares of the class outstanding);

(2) "Promptly" upon crossing 10-percent beneficial ownership; and

(3) Once over 10 percent, "promptly" after beneficial ownership increases or decreases by more than 5 percent.

(c) 13d-1(d) Exempt Investors: Investors who are or become the beneficial owner of more than 5 percent of a class of subject securities *but* who have not made an "acquisition" subject to Section 13(d) are permitted to file on Schedule 13G (e.g., those who become beneficial owners of more than 5 percent of a class of subject securities as a result of a stock buy-back or those who owned the subject security prior to the subject security becoming registered under the

Exchange Act).[4] This provision is available regardless of control intent or ownership level. The ability to file under 13d-1(d) is lost if the investor acquires more than 2 percent of the class of subject securities within any 12-month period. For example, if the investor acquired 1.5 percent of the subject security two months prior the Exchange Act registration and one month following the registration acquired another 0.6 percent of the subject security, the ability to file under 13d-1(d) would be lost, and instead of filing under Rule 13d-1(d) after the year-end, the investor would instead file under Rule 13d-1(b), 13d-1(c) or file a Schedule 13D, as appropriate.

(i) The initial Schedule 13G filing is required within 45 days of the end of the calendar year if beneficial ownership exceeds 5 percent as of the end of the calendar year.

(ii) Amendments are required within 45 days of the end of the calendar year if, as of Dec. 31, there is any change in the information previously reported (unless the only change is a change in the percentage beneficially owned and such change is a result of a change in the number of shares of the class outstanding).

C. Section 16 Reporting Requirement Trigger

1. Upon becoming an officer, director[5] or greater than 10-percent “beneficial owner” of any subject security

2. “Beneficial ownership” for determining who is subject to Section 16 is, for the most part, the same as the Section 13(d) beneficial ownership determination. Therefore a Schedule 13D/G filer that is a greater than 10-percent beneficial owner separately will be subject to Section 16 reporting. Accordingly, reporting persons are typically the same as under the Section 13(d) analysis.

D. What Is Reported and Subject to Matching Under Section 16(a)?

1. The beneficial ownership test used to determine whether a person is subject to Section 16 as a greater than 10-percent beneficial owner is different from the test used to determine what is reported under Section 16(a) and what is subject to matching for purposes of Section 16(b). Section 16(a) requires the disclosure of, and Section 16(b) subjects to profit disgorgement under Section 16, any equity securities of the issuer in which the reporting persons have a direct or indirect “pecuniary interest” (discussed below).

2. The use of different tests for determining greater than 10-percent beneficial ownership on the one hand and what is included on Section 16 reports on the other hand can result in a filer not reporting securities that were taken into account when determining whether the filer was subject to Section 16. It can also result in securities that are reported under Section 16 being excluded from Section 13(d) reporting and vice versa.

3. Pecuniary interest is defined as the “opportunity, directly or indirectly, to profit or share in any profit derived from a transaction in the subject securities” (Rule 16a-1(a)(2)(i)).

[4] This comes up most often where an issuer’s securities are held, such as by a private equity or venture capital fund, prior to the issuer’s initial public offering (concurrently with which the securities will become registered under the Exchange Act).

[5] It is possible for an entity to be treated as a director for purposes of Section 16 if it can be shown that the entity has deputized an individual to sit on the board of an issuer in order to represent the interests of the entity. If an entity is deemed to be a director-by-deputization, the entity will be treated as a director and subject to Section 16 as such regardless of whether the entity beneficially owns more than 10 percent of the issuer’s securities.

(a) An indirect pecuniary interest is defined to include a general partner's proportionate interest in the portfolio securities held by a general or limited partnership to the extent of the greater of the partner's share of the partnership's profits or capital account (Rule 16a-1(a)(2)(ii)(B)).

(b) An investment manager will have an "indirect pecuniary interest" with respect to a class of an equity security if it receives a performance fee based, in part, on the security's performance *unless*, with respect to the performance fee: (i) the performance fee is calculated over a period of one year or more; and (ii) the equity securities of the issuer do not account for more than 10 percent of the market value of the portfolio of the applicable fund or account (Rule 16a-1(a)(2)(ii)(C)).[6]

(c) Asset-based fees are excluded from the definition of indirect pecuniary interest (Rule 16a-1(a)(2)(ii)(C)).

(d) A Fund will be deemed to have a direct pecuniary interest in any securities directly held by it.

4. Forms Filed Under Section 16(a)

(a) Form 3 – Initial Statement of Beneficial Ownership of Securities: Must be filed within 10 days of becoming an officer, director or greater than 10-percent "beneficial owner" to report all equity securities in which the filer has a pecuniary interest as of the time of crossing 10 percent (except that if the filing is a result of the initial registration of the issuer's securities under the Exchange Act (e.g., in connection with an IPO) the filing is required to be made on the date the issuer's registration statement is declared effective by the SEC).

(b) Form 4 – Statement of Change of Beneficial Ownership of Securities: Must be filed within two business days after a change in pecuniary interest takes place.

(c) Form 5 – Annual Statement of Beneficial Ownership of Securities: Must be filed within 45 days of the issuer's fiscal year end to report transactions that took place in the prior year that should have been reported but were not. It can also be used to report certain transactions exempt from 16(b). If there are no transactions required to be filed on a Form 5, no such filing is made for the year.

5. Section 16(b) Short-Swing Profit Liability

(a) Section 16(b) imposes liability for short-swing profits from the issuer's equity securities (including derivative securities) upon all persons required to file reports under Section 16(a).

(b) Section 16 insiders must disgorge to the issuer any profits realized as a result of a purchase and sale or sale and purchase of any equity securities of the issuer within a period of less than six months ("short-swing profits").

(c) With respect to 10-percent beneficial owners, the purchase that puts the beneficial owner over the 10-percent threshold does not qualify as a "purchase" subject to Section 16(b); only purchases made after becoming a greater than 10-percent beneficial owner will give rise to short-swing profits when matched against sales occurring within six months and while a Section 16 insider.

[6] The determination of "market value" is not defined. A factor that can be relevant to the determination includes how the Fund or account carries the position on its books.

(d) The "lowest-in, highest-out" method of calculating matching transactions is used to calculate profits under Section 16(b). Under this approach, "the highest sale price during the six month period is matched against the lowest purchase price in that period, followed by the next highest sale price and next lowest purchase price and so on, until all shares have been included" irrespective of the order in which the transactions were executed. Under this approach, it is possible for an insider to have an actual loss but a "realized" profit that is payable under Section 16(b).

Example

Transactions Investment Status	
Transaction 1: Buy 1,000,000 shares at $10 ($10M)	$10,000,000
Transaction 2: Buy 1,000,000 shares at $20 ($20M)	$30,000,000
Transaction 3: Sell 1,000,000 shares at $20 ($20M)	$10,000,000
Transaction 4: Sell 1,000,000 shares at $5 ($5M)	$5,000,000

Total Loss = $5,000,000

Under §16(b)
Lowest price in = $10 = $10,000,000
Highest price out = $20 = $20,000,000
Total Realized Profit = $10,000,000

III. Rule 14e-4: The Short Tender Rule

A. Rule 14e-4 Generally

1. Rule 14e-4 prohibits a person from tendering shares into a partial tender offer unless the person is "net long" both at the time of tender and at the end of the proration period of the tender offer. Under Rule 14e-4(a)(1) a person's "net long position" is the excess, if any, of its "long position" over its "short position."

2. In adopting Rule 14e-4 (which at the time was Rule 10b-4; it was designated as Rule 14e-4 in 1990), Congress indicated that its intention was for each shareholder to receive equal treatment based upon the shareholder's interest in the securities that are the subject of a tender offer. By short tendering or hedging their tender, market professionals reduce their proration risk while increasing the proration risk of all those who cannot short or engage in hedged tendering, because the short or hedged tendering often leads to over tendering (i.e., the same shares being tendered more than once). The SEC has observed that short and hedged tendering often requires access to borrowed shares, which market professionals have a clear advantage in obtaining access to.[7]

B. Things to Note When Calculating a Person's Long and Short Positions

1. Rule 14e-4(a)(1)(i) defines a person's long position to include the amount of subject securities that such person:

(a) Or his agent has title to or would have title to but for having lent such securities; or

[7] *See* Release No. 34-26609 (March 8, 1989).

(b) Has purchased, or has entered into an unconditional contract, binding on both parties thereto, to purchase but has not yet received; or

(c) Has exercised a *standardized* call option for; or

(d) Has converted, exchanged, or exercised an equivalent security for; or

(e) Is entitled to receive upon conversion, exchange or exercise of an equivalent security.

2. Rule 14e-4(a)(1)(ii) defines a person's short position to include the amount of subject securities that such person:

(a) Has sold, or has entered into an unconditional contract, binding on both parties thereto, to sell; or

(b) Has borrowed; or

(c) Has written a *non-standardized call option*, or granted any other right pursuant to which his shares may be tendered by another person; or

(d) Is obligated to deliver upon exercise of a *standardized* call option *sold on or after the date that a tender offer is first publicly announced* or otherwise made known by the bidder to holders of the security to be acquired, *if* the exercise price of such option is lower than the highest tender offer price or stated amount of the consideration offered for the subject security. For the purpose of this paragraph, if one or more tender offers for the same security are ongoing on such date, the announcement date shall be that of the first announced offer.

IV. Derivatives Update

A. Margin Requirements for Non-Cleared Swaps

1. A final rule was adopted by a group of banking regulators (the "prudential regulators") on Oct. 22, 2015 establishing minimum margin requirements for non-cleared swaps and non-cleared security-based swaps.[8] The rule generally requires dealers to collect and post initial margin with a limited set of counterparties and collect and post variation margin with all others (subject to limited exceptions). The CFTC is expected to issue its own rule for margining non-cleared swaps in the near future.

2. The final rule imposes requirements depending on: (i) whether the relevant entity is a "Financial End User," and (ii) whether such entity has a "Material Swaps Exposure."

(a) The term Financial End User is broadly defined to cover various forms of investment funds, including: (i) a private fund as defined in section 202(a) of the Investment Advisers Act of 1940; (ii) an entity that is deemed not to be an investment company under Section 3 of the Investment Company Act of 1940 pursuant to Rule 3a-7; and (iii) a commodity pool, commodity pool operator or commodity trading advisor.

[8] *See* Final Rule to Establish Margin and Capital Requirements for Covered Swap Entities (unofficial text) (the "Final Rule"). The Final Rule was jointly adopted by the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Farm Credit Administration and the Federal Housing Finance Agency. For ease of reference, the term "swaps" as used herein will refer to both "swaps" and "security-based swaps" unless the context requires otherwise.

(b) An entity has Material Swaps Exposure if it and its affiliates have an average daily aggregate notional amount of non-cleared swaps with all counterparties for business days in June, July and August of the previous calendar year that exceeds $8 billion. [9] Managers likely will be required to represent to dealers whether any fund has a Material Swaps Exposure.

3. Margin Requirements

(a) Initial Margin: Dealers must both collect and post initial margin for swaps entered into with Financial End Users that have a Material Swaps Exposure. Dealers are permitted to apply a threshold of up to $50 million, an exposure below which will not require the exchange of initial margin. Dealers do not have any obligation to collect or post initial margin with non-Financial End Users or Financial End Users without a Material Swaps Exposure. Initial margin may be calculated either by a dealer's pre-approved proprietary model or by using a standardized margin schedule set forth in the final rule. Initial margin collected in excess of the $50-million threshold must be segregated with a third-party custodian.

(b) Variation Margin: Dealers are generally required to collect and post variation margin for all swaps entered into with a Financial End User regardless of material swaps exposure (and without any permissible threshold amount).

(c) Eligible margin types include immediately available cash funds denominated in any major currency or certain types of non-cash collateral subject to a fixed haircut based on asset class.

(d) Parties to an eligible master netting agreement ("EMNA") are generally permitted to calculate initial margin and variation margin on an aggregate net basis across all non-cleared swaps. Parties to an EMNA can elect to maintain a separate set of legacy swaps executed prior to the applicable compliance date that will not be subject to the margin rules.

4. Compliance Dates

The initial margin rule will be phased in between Sept. 1, 2016 and Sept. 1, 2020 depending on the swap activity levels of the two counterparties. Variation margin requirements begin Sept. 1, 2016 for entities with high average daily notional exposure, and March 1, 2016 for all other counterparties.

B. CFTC Aggregation Rules – 2015 Update

1. In September 2015 the CFTC issued proposed modifications to its 2013 proposed rules on position limit aggregation in Part 150 of the CFTC Regulations (The "2015 Proposal" and "2013 Proposal" respectively).[10] Both proposals generally require a person or owner (an "owner") to aggregate its own positions with any account or entity that is not a pooled investment vehicle in which such person has a 10-percent or greater ownership or equity interest (an "owned entity").[11] The proposed

[9] The term "affiliate" is defined to mean entities that are consolidated on the same financial statements prepared in accordance with GAAP (or similar foreign standards) and is unlikely to include two funds separately managed by the same investment manager. Where the assets of an investment fund are consolidated with the assets of its investment manager, such as during seeding, the entities would be considered affiliated for purposes of the final rule.

[10] CFTC Supplemental Notice of Proposed Rulemaking: Aggregation of Positions, 80 Fed. Reg. 58365 (Sept. 29, 2015); CFTC Notice of Proposed Rulemaking: Aggregation of Positions, 78 Fed. Reg. 68946 (Nov. 15, 2013).

[11] Certain aspects of these aggregation rules and their exemptions are already currently applicable.

position limit rules apply to many futures and options contracts as well as economically equivalent swaps.[12]

2. The 2013 Proposal permitted the disaggregation of positions held by owned entities in the following scenarios:

   (a) An owner that meets certain requirements and who owns between 10 percent and 50 percent of an owned entity may disaggregate positions by filing a notice with the CFTC.

   (b) An owner meeting the same requirements and who owns greater than 50 percent of an owned entity may disaggregate positions only with prior approval from the CFTC.

3. The 2015 Proposal removed the distinction between scenarios described in 2(a) and 2(b) above so that, subject to the below requirements, any owner who owns greater than 10 percent of an owned entity may disaggregate positions by filing a notice with the CFTC. The requirements are as follows:

   (a) No knowledge of the trading decisions of the other.

   (b) The entities trade pursuant to separately developed and independent trading systems.

   (c) The entities have and enforce written procedures to preclude each from having knowledge of, gaining access to, or receiving data about trades of the other.

   (d) The entities do not share employees who control the trading decisions of either.

   (e) The entities do not have risk management systems that permit the sharing of trades or trading strategies.

4. The 2015 Proposal did not modify the 2013 Proposal's requirement that two entities with substantially identical trading strategies must aggregate regardless of whether an exemption would apply.

V. Spoofing

A. What Is Spoofing?

"Spoofing" is defined as "bidding or offering with the intent to cancel the bid or offer before execution."

B. Spoofing Is Unlawful.

1. Spoofing is prohibited by several statutes and regulations, primarily by the anti-spoofing provision of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act. Section 747 of the Act added to Section 6c(a) of the Commodity Exchange Act that: "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 … 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)."

2. The Chicago Mercantile Exchange ("CME") also prohibits spoofing under Rule 575, Disruptive Practices Prohibited:

[12] For pooled investment vehicles, aggregation is generally for investors who have a 25-percent or greater ownership in a vehicle where its manager relies on the CFTC Rule 4.13(a)(3) exemption from registration as a commodity pool operator.

(a) "No person shall enter or cause to be entered an order with the intent, at the time of order entry, to cancel the order before execution or to modify the order to avoid execution;

(b) No person shall enter or cause to be entered an actionable or non-actionable message or messages with intent to mislead other market participants."

C. Both the SEC and DOJ have shown a new interest in pursuing spoofing cases, evidenced by the first-ever criminal conviction for spoofing, and various other civil and criminal cases and settlements involving spoofing.

1. *United States v. Coscia*, No. 14-cr-00551 (N.D. Ill. Nov. 3, 2015) represented the first-ever criminal charge and conviction for spoofing. Michael Coscia, a high-frequency trader, was convicted for manipulating commodity future contract markets that were part of CME Group Inc. (including the CME, the Chicago Board of Trade, the New York Mercantile Exchange, and Commodity Exchange Inc.). Coscia traded on various CME Group Markets and ICE Futures Europe, a futures exchange based in London. Coscia would enter large-volume orders and immediately cancel them before they could be executed. The large non-bona fide orders would create a false impression and cause the market to act in a way that allowed Coscia to profit off of bona fide trades in the opposite direction. Coscia also utilized computer programs to implement this scheme, which automatically canceled certain orders and also looked for favorable market conditions such as price stability, low volume at the best price, and narrow bid-ask spreads. Coscia's spoofing also took another form. He would place a series of buy and sell orders in which he would purchase futures contracts in the Euro FX market at a deflated price and immediately sell them for a profit. For example, Coscia would place a small buy order at a price below market price, then place multiple large sell orders to drive the price down and cause his buy order to be executed, and then would immediately close his open sell orders. Coscia would follow that by doing the same thing in the opposite direction, placing one small sell order at above market price and then several large buy orders to drive the price up. After the sell order was executed, Coscia would cancel the buy orders. Coscia could accomplish this whole series of transactions in less than one second. Coscia was convicted on six counts of market manipulation and six counts of spoofing. Sentencing is scheduled for 2016. Coscia also settled a case with the CFTC by agreeing to pay $2.8 million and serve a one-year trading ban without admitting or denying any of the charges.

2. *In the Matter of Behruz Afshar et al.*, Release No. 9983 (Dec. 3, 2015): On Dec. 3, 2015, the SEC charged three individuals with, among other things, perpetrating a spoofing scheme to earn liquidity rebates from the Nasdaq OMX PHLX (the "PHLX"). The respondents allegedly placed bona fide large all-or-none orders (orders that were undisplayed and must be executed in their entirety or not at all) in order to collect a rebate the PHLX offered for orders that created liquidity (as part of its "maker-taker" fee model). The respondents would then spoof the market into executing the large all-or-none orders by placing smaller non-bona fide orders in the same option and at the same price, but on the opposite side. These smaller non-bona fide orders would alter the option's best bid or offer to "spoof" the market into submitting orders at the new best bid or offer to execute the all-or-none order. The respondents then would cancel any open orders. Allegedly, the respondents collected over $225,000 through this spoofing scheme.

3. *United States v. Milrud*, No. 2:15-cr-00455 (Sept. 10, 2015); *SEC v. Milrud*, No. 15-CV-00237 (D.N.J. Jan. 13, 2015): Aleksandr Milrud has simultaneous criminal and civil cases being pursued against him for securities fraud, specifically spoofing. Milrud allegedly orchestrated a spoofing scheme that involved recruiting overseas-based traders, whom he would instruct to place corresponding bona fide and non-bona fide trades in order to earn an illegal profit. Specifically, the traders would place numerous orders in one direction for a certain stock, progressively lowering or increasing the price

in small increments (usually a penny) to increase or decrease the stock price. Milrud took certain steps in an attempt to conceal the spoofing scheme, including giving each trader two accounts (one for bona fide trades and one for non-bona fide trades) and keeping profits intentionally low on each stock. The civil case is currently stayed, but in the criminal case Milrud recently agreed to plead guilty to one count of conspiracy to commit securities fraud in violation of 18 U.S.C. § 371.

4. *United States v. Sarao*, No. 15-cr-00075 (N.D. Ill. April 21, 2015): In a spoofing case related to the "Flash Crash" on May 6, 2010, Navinder Singh Sarao was charged with wire fraud, commodities fraud, commodities manipulation and spoofing. Sarao allegedly would place multiple non-bona fide large volume orders at different price points on the CME for the E-Mini S&P 500, a futures contract based on the S&P 500. The orders would fraudulently cause the market to react by selling E-Mini, causing the price to fall. Sarao used automated trading functions and programs to minimize the risk of actually executing his non-bona fide orders by ensuring that his offers were never the best offer available. The SEC described Sarao's strategy as a "dynamic layering technique" whereby he would almost constantly modify his non-bona fide offers to stay slightly below the market or best price. As Sarao caused the market to move downward, he would repeatedly sell futures contracts and then buy them back at a lower price. As the price moved back upward, Sarao would do the opposite and repeatedly buy futures contracts and then sell them at a higher price. In addition to his primary fraudulent scheme, Sarao would also flash large non-bona fide orders and then place smaller bona fide orders in the opposite direction.

5. *In the Matter of Briargate Trading, LLC and Eric Oscher*, Release No. 9959 (Oct. 8, 2015): A trading firm and one of its principals were charged with utilizing spoofing to manipulate the market. Specifically, the respondents allegedly placed non-bona fide orders on the NYSE, placed bona fide orders in the opposite direction away from the NYSE, and then cancelled the non-bona fide orders all before the market opened. These pre-opening orders would be disseminated through Order Imbalance Messages before the market opened, causing the opening price of a stock to change and allowing the respondents to earn profits on the bona fide orders. The respondents were charged with violating Section 17(a) of the Securities Act and Sections 9(a)(2) and 10(b) of the Exchange Act, and Rule 10b-5 thereunder. Briargate ultimately settled the case, agreeing to pay a civil money penalty of $350,000. Oscher also settled and agreed to pay a $150,000 civil money penalty. The respondents jointly agreed to pay disgorgement of $525,000 and prejudgment interest of $37,842.32. There were no bars or trading suspensions, and the respondents did not admit or deny any of the SEC's findings, except Oscher admitted the findings as true for the sole purpose of Section 523 of the Bankruptcy Code.

VI. Enforcement: Shareholder Activism

A. The SEC has been showing increased attention and interest in shareholder activism. For example, both Chair White and Commissioner Gallagher have recently spoken about activism, its benefits and harms, and the role of the SEC in addressing activism.[13]

B. The SEC has not publicized any activist-focused enforcement decisions, but that does not mean the SEC is not investigating certain activist behavior. In fact, media reports indicate that SEC is investigating certain activist behavior.

C. Although there are various enforcement risks that activists in particular face, acting as a group is one of, if not the, most noteworthy and most of interest to the SEC.

[13] *See* Daniel M. Gallagher, SEC Commissioner, Activism, Short-Termism, and the SEC: Remarks at the 21st Annual Stanford Directors College (June 23, 2015); Mary Jo White, SEC Chair, A Few Observations on Shareholders in 2015 (March 19, 2015) (discussing in part the current activism landscape).

1. Commissioner Gallagher, while discussing the SEC's role with activist hedge funds, recently stated: "The most obvious issue presented to the Commission is the Section 13 reporting obligations that we administer."[14]

2. Section 13(d) deems two or more persons to qualify as a single person for the purposes of reporting under Section 13(d) when they act "as a partnership, limited partnership, syndicate, or other group for the purpose of acquiring, holding, or disposing of securities of an issuer."

3. The U.S. Court of Appeals for the Second Circuit has held that "the touchstone of a group within the meaning of section 13(d) is that the members combined in furtherance of a common objective."[15]

4. A recent *Wall Street Journal* article reported that the SEC is conducting multiple investigations into whether some activist investors acted as a group without adequately reporting under Section 13(d).[16] Specifically, the article stated that the SEC had sent a letter to an activist fund inquiring as to whether the fund had any "agreements or understandings" with another fund that was orchestrating its own proxy contest against the same target company.

VII. New Enforcement Initiatives in the Futures and Options World

A. Recent history demonstrates a new willingness on the part of the futures and options exchanges to assert enforcement actions against market participants.

B. This trend is most notable when reviewing recent actions by the CME Group market regulation division.

   1. In recent years, the CME has made a number of enforcement hires in its New York and Chicago offices. Many of these new hires are former criminal prosecutors and defense lawyers who know how to try cases and take them through a trial.

   2. CME enforcement actions that involve market manipulation (including spoofing) are headline events (Attachment A).

   3. However, at the same time, CME enforcement of other rule violations, including technical violations that may not evidence scienter, has increased. Enforcement actions have focused on position limit violations, non-bona fide exchanges for related products ("EFRPs"), transitory EFRPs and improper futures for futures exchanges. For many of these matters, the interpretation of the CME rules is very technical and may be non-intuitive.

   4. Market participants can find themselves on the receiving end of an enforcement inquiry or action even if they are exempt from CFTC registration. Market-level enforcement is triggered by trading, not by any registration or other regulatory status.

[14] Daniel M. Gallagher, SEC Commissioner, Activism, Short-Termism, and the SEC: Remarks at the 21st Annual Stanford Directors College (June 23, 2015).

[15] *Roth v. Jennings*, 489 F.3d 499, 508 (2d Cir. 2007 (quoting *Wellman v. Dickinson*, 682 F.2d 355, 363 (2d Cir. 1982)).

[16] Liz Hoffman, Aruna Viswanatha and David Benoit, "SEC Probes Activist Funds over Whether They Secretly Acted in Concert," *The Wall Street Journal* (June 14, 2015).

VIII. New Developments in the Market Abuse Regime in Europe

A. Market Abuse Regulation: The Market Abuse Regulation (part of the MAD II legislative package) ("MAR") will enter into force in EU member states on July 3, 2016. The key changes introduced by MAR include:

1. Broadening the scope of financial instruments covered by the market abuse regime to include any financial instruments admitted to trading on a multilateral trading facility or organized trading facility (i.e., a new type of trading venue to be introduced by MIFID II) and any instruments the price or value of which depends, or has an effect, on any such financial instrument (e.g., CDS);

2. Inclusion of emission allowances and related auctioned products within the scope of MAR;

3. Inclusion of spot commodity contracts within the scope of the prohibition against market manipulation where the behavior is likely to have an effect on the price of commodity derivatives within the scope of MAR;

4. The widening of the existing market manipulation offence and the creation of a new offence of "attempted market manipulation";

5. A new regime for reporting suspicious transactions and orders;

6. A new framework for disclosures of inside information in the course of taking market soundings; and

7. A new whistleblowing (to the regulator) and administrative sanctions regime.

B. There has been increased scrutiny of insider dealing and market manipulation by the FCA in the United Kingdom. Recent FCA enforcement actions have focused on insider dealing, improper disclosure of inside information, market manipulation and failure to report a suspicion of market abuse.

IX. ERISA Provisions in Trading Documents

A. ERISA issues often arise, even for non-plan asset funds, in the various trading documents into which a hedge fund enters, such as the Prime Brokerage Agreement, ISDAs, Master Repo Agreements, Master Securities Loan Agreements, FX Prime Brokerage Agreements, Master Futures Agreements, etc., because these documents will almost assuredly contain ERISA representations.

B. The base line starting point is typically a no-plan-asset and no-prohibited-transaction representation and warranty given by the hedge fund and its investment manager. This language is likely to be set forth in the trading documents even if the hedge fund is intended to be a plan asset fund, unless the investment manager's personnel impress on the counterparty that the hedge fund will be a plan asset fund.

C. In a non-plan asset fund, the trading documents will typically contain representations that the assets of the fund are not plan assets, that entering into the agreement does not give rise to a prohibited transaction under ERISA and that the effecting of individual transactions under the agreement does not give rise to a prohibited transaction under ERISA.

D. These representations are legitimate requests, but the key is to attempt to negotiate the agreement in such a way that a violation of the representation should not give rise to a default or an additional termination event unless there is, in fact, a prohibited transaction.

E. In reality, even if the investment manager is not a "qualified professional asset manager" as defined under the Department of Labor's QPAM Exemption and the fund slips into plan asset status by accident, neither entering into the master agreement, nor into any individual transactions thereunder, will give rise to a prohibited transaction because Section 408(b)(17) of ERISA (the so-called "service provider exemption") should exempt these activities as long as the pricing of the transaction is "right." The service provider exemption is available regardless of whether the hedge fund intends to be a plan asset vehicle and even if the hedge fund's governing documents affirmatively stated that the hedge fund will not be a plan asset vehicle.

F. The pricing should always be "right" because the individuals negotiating the documents and causing the individual transactions on behalf of the hedge fund are investment professionals with a strong grasp of the market pricing. Thus, it should be difficult for anyone to argue that the counterparty "pulled the wool" over the investment manager's eyes in connection with any particular transaction, rendering the service provider exemption unavailable.

G. Note the one exception to the availability of the service provider exemption. It is not available if the counterparty caused one of the plans to invest in the particular hedge fund.

H. For a plan asset fund, the counterparty will typically require the hedge fund and the investment manager to represent that the investment manager is a "qualified professional asset manager" within the meaning of the DOL's QPAM Exemption.

I. Normally this should not be an issue, as the investors will also require that the investment manager be a QPAM.

J. Although it may be possible to conduct all of the hedge fund's transactions using the service provider exemption, it is much more difficult negotiating for such a provision with various of the counterparties. Even if this goal is attainable, the counterparties will pick and choose the transactions for which they will agree to use the service provider exemption. Further, because of a DOL Advisory Opinion, the service provider exemption will typically not be available in connection with cleared swaps. No such limitations should be expected when the investment manager is a QPAM.

K. Some counterparties will negotiate the ERISA provisions so that the investment manager can either be a QPAM or rely on the service provider exemption. This is particularly important if a plan asset fund intends to enter into repos, as the DOL has declared that the QPAM Exemption is not available for repo transactions and the QPAM Exemption by its terms does not apply to securities-lending transactions.

Attachment A: Selected CME Enforcement Settlements with Buy-Side Market Participants (October 2013 Through October 2015)

Date	Violator	Alleged Facts of Settlement	Remedies
10/2/15	BBL Commodities LP	Violated Rule 562 by holding a futures equivalent position in excess of the standard expiration month limit by 1,553 contracts (38.83%)	Fine of $25,000; disgorgement of $195,384.40
8/21/15	Blenheim Capital Mgmt. LLC	Violated Rule 538.H with insufficient documentation of two EFRPs	Fine of $10,000
7/24/15	Pac. Inv. Mgmt. Co.	Violated Rule 562 by holding end-of-day net short positions in excess of the single-month position limit by 44 contracts (0.676%) and in excess of the all-months position limit by 375 contracts (5.769%); and by holding end-of-day net short positions in excess of the single-month position limit by 107 contracts (1.646%) and the all-months position limit by 1,090 contracts (16.769%)	Fine of $35,000
6/1/15	Hayman Capital Mgmt. LP	Violated Rule 562 by holding a long position in excess of the standard expiration month limit by 300 contracts (43.33%)	Fine of $25,000; disgorgement of profits of $709,270
4/17/15	SummerHaven Inv. Mgmt. LLC	Violated Rule 538.H with insufficient documentation of one EFRP	Fine of $7,500
4/17/15	Daniel Shak (SHK Asset Mgmt.)	Violated NYMEX Legacy Rule 443 by exceeding accountability limits for three days	Fine of $25,000
3/23/15	Citadel Sec. LLC	Violated CME Rule 432.Q when, because of a software malfunction, it entered a series of unintentional orders on the Globex platform, which caused an atypical short-term increase in trading volume and affected prices	Fine of $70,000
12/19/14	Rahul Seksaria (PIMCO)	Violated Rules 432.G, 432.Q, 539.A by orchestrating trades in futures contracts opposite one of his employer's client suspense accounts	Fine of $65,000; restitution of $2,675; suspension from all CME platforms for three months
10/27/14	Sun Life Fin. Inc.	Violated Rules 432.W, 534 by executing two trades totaling 989 contracts on both sides of the transactions; firm also failed diligently to supervise its employees	Fine of $50,000
9/25/14	Weidong Ge (Shanghai Chaos)	Violated Rules 534, 432.W by directing traders on two occasions to execute wash trades and by failing diligently to supervise them	Fine of $35,000 Fine of $15,000
8/15/14	Vermillion Asset Mgmt. LLC	Violated Rule 538.H with insufficient documentation of EFRPs	Fine of $20,000
7/3/14	EMF Fin. Prods. LLC	Violated Rule 538 by inaccurately reporting transactions as EFRPs and by failing to ensure proper documentation for EFRPs	Fine of $12,500 Fine of $12,500
6/16/14	RCG Holdings LLC	Violated Rule 562 by holding a position in excess of the standard expiration month limit by 81 contracts (8.1%)	Fine of $15,000; disgorgement of $5,482.68

Date	Violator	Alleged Facts of Settlement	Remedies
5/2/14	Ontario Teachers' Pension Plan Bd.	Violated Rule 562 by holding positions in excess of the single month speculative position limit by 2.1% and 2.6%	Fine of $15,000; disgorgement of $17,899.82
5/1/14	D.E. Shaw & Co. LP	Violated Rule 562 by holding a position in excess of standard position limit by 807.5 contracts (80.75%)	Fine of $75,000
		Violated Rule 562 by simultaneously holding financial contracts and physical contracts	Fine of $25,000
2/7/14	Vermillion Asset Mgmt. LLC	Violated Rule 562 by simultaneously holding financial contracts and physical contracts	Fine of $45,000
		Violated Rule 562 by simultaneously holding financial contracts and physical contracts	Fine of $35,000
2/7/14	GMT Capital Corp.	Violated Rule 562 by holding a position in excess of the standard expiration month limit by 1,555 contracts (155.50%)	Fine of $40,000; disgorgement of $8,820
12/23/13	Iken Capital LLP	Violated Rules 432.Q and 432.W by failing adequately to monitor its auto-spreader	Fine of $90,000
10/24/13	Karya Capital Mgmt. LP	Violated Rule 562 by holding an aggregate intraday long position in excess of the all contract months combined speculative position limit by 261 contracts (5%); then by 64 contracts (1%); then by 264 contracts (5%)	Fine of $10,000, and disgorgement of $166,325, in connection with first violation; fined $30,000 in connection with latter two violations
9/30/13	Cypress Energy Capital Mgmt. LP	Violated Rule 562 by holding a short position in excess of the expiration month limit by 77 contracts (7.7%)	Fine of $15,000; disgorgement of $5,900
9/24/13	AQR Capital Mgmt. LLC	Violated Rule 562 by holding a position in excess of the single month speculative position limit by 323 contracts (2%); firm had violated position limit rules twice before within seven-month period	Fine of $70,000; disgorgement of $925

Navigating Risks in the New Enforcement Environment

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JANUARY 19, 2016

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Harry focuses his practice on complex commercial litigation and regulatory matters for financial services industry clients, including hedge funds, funds of funds and private equity funds, prime and clearing brokers, introducing brokers and interdealer brokers, and auditors and administrators. He has substantial experience in both securities regulatory matters and private litigation, including investigations by the SEC, U.S. Attorneys' offices, DOJ, CFTC, FTC, state attorneys general, state securities regulators and self-regulatory organizations. Harry has litigated numerous cases in federal and state courts throughout the United States, including his recent victory for an inter-dealer broker in an arbitration brought by one of its competitors for alleged misappropriation of trade secrets as well as in a 4-1/2 month jury trial in a raiding case, and his successful representation of a prime broker in a high-profile jury trial brought by the bankruptcy trustee of a failed hedge fund. Over the course of a career spanning more than 25 years, Harry has represented clients in investigations and litigations involving allegations of insider trading, market manipulation, market timing and late trading, misconduct involving PIPEs, short-swing profits, securities and common law fraud, advertising, breach of fiduciary duty, employee raiding and other employment issues, misappropriation of trade secrets and other business torts, and breach of contract, among other claims.

Harry is recognized as a leading lawyer by *The Legal 500 United States* and by *New York Super Lawyers*. He is a member of the American Bar Association, the New York State Bar Association, the New York County Lawyer's Association, the New York City Bar Association, the Federal Bar Council, the Federalist Society and Securities Industry and Financial Markets Association's Compliance and Legal Division, and he is the former chair, co-chair and vice chair of the Trade Regulation Committee. A prolific author and speaker, Harry is the editor of and author of several chapters in *Insider Trading Law and Compliance Answer Book* (Practising Law Institute), a definitive treatise written in question and answer format and designed to help educate and protect clients from regulatory exposure. He is also the author of a chapter in *Private Fund Dispute Resolution*, which serves as a primer regarding U.S. and U.K. regulatory inquiries, investigations and examinations of private investment funds, and he recently published an article concerning short selling under Rule 105. He has presented about a wide range of topics, including how hedge funds can protect themselves against insider trading, limiting liability for compliance officers, and civil litigation relating to securities enforcement.

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Adam has been recognized in *Chambers USA* for his "immense talent as a trial lawyer" and "strong advocacy skills," in *The Legal 500 United States* as "an aggressive trial advocate," and in *Benchmark Litigation: The Definitive Guide to America's Leading Litigation Firms and Attorneys* as a "celebrated government investigations practitioner." He has also been recognized in *The Best Lawyers in America*, *Expert Guide to the World's Leading White Collar Crime Lawyers*, *International Who's Who of Business Crimes Defense Lawyers*, *Global Investigations Review*, *Washingtonian Magazine* and *Washington DC Super Lawyers*. Adam was named "Government Investigations Attorney of the Year" for 2015 and "Life Sciences Star" from 2013 to 2015 in *LMG Life Sciences*. In addition, he was recognized in the *National Law Journal*'s "Hot Defense List" for his jury trial victory on behalf of a former pharmaceutical executive in a criminal case charging conspiracy and violations of the federal Anti-Kickback Statute. Adam is a former Assistant U.S. Attorney for the Southern District of New York, and he received the Director's Award for Superior Performance from the U.S. Department of Justice in 1990. He is an adjunct professor at The George Washington University Law School and has been an instructor at Georgetown University Law Center's National Institute of Trial Advocacy (NITA) since 1992. He also serves on the alumni board of the Fordham University School of Law. Adam frequently speaks about topics of interest to the private funds industry, including, most recently, audit committee investigations, recovery of assets, and obtaining and negotiating corporate deferred and non-prosecution agreeements.

Adam received his J.D. from Fordham University School of Law and his B.A. from Trinity College.

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David's practice focuses on corporate, securities and bank regulatory matters. He primarily represents institutional and entrepreneurial investment managers, financial services firms and private investment funds in all aspects of their businesses. He structures investment management and financial services firms as well as hedge, private equity, credit, distressed investing and hybrid funds, energy funds, co-investments, funds of funds and scalable platforms for fund sponsors. David provides legal and business advice on fund structuring, fundraising, management company partnerships, compensation plans, succession plans, seed and strategic investments and spinoffs of investment teams. His work also includes counseling clients on finding practical solutions to regulatory and compliance requirements, including the Volcker Rule, and managing conflicts of interest with an emphasis on reducing legal risk to the business.

David has been named a leader in his field by *Chambers Global* and *Chambers USA* and has been recognized by *The International Who's Who of Private Funds Lawyers*, *PLC Cross-border Private Equity Handbook*, *The Legal 500 United States* and *Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers*. A member of the Advisory Board of The Financial Executives Alliance and past member of the Banking Law Committee of the New York City Bar Association, David is a sought-after writer and speaker. Works he has authored or co-authored include the chapter "Management Company Structures and Terms" in *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press), "Hedge Fund Names: What a Hedge Fund Manager Should Do Before It Starts Using a Name" in *The Hedge Fund Law Report* and "Just Like Starting Over: A Blueprint for the New Wall Street Firm," published by *The Deal*. He has addressed topics at conferences and seminars including co-investment vehicles, investing in the oil and gas sector, liquidity events, exits and succession planning.

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Jen has a diverse practice focusing on complex commercial litigation, bankruptcy-related litigation, and regulatory investigations and counseling. She has represented clients in state and federal courts and before regulatory bodies, and has also counseled clients on anti-money laundering and anti-corruption and sanctions rules and regulations. Her class action litigation experience includes defending various parties in Madoff-related litigation, including defendants in a putative class action alleging violations of federal securities laws, successfully settling an ADR securities class action for a Brazilian company, and prevailing on a motion to dismiss a consumer fraud class action. Jen's complex commercial cases have involved defending a major bank in lawsuits brought by investors in a credit facility, successfully defending against RICO claims and settling common law tort claims; representing hedge fund advisory board members in connection with opposing third-party subpoenas served on them, obtaining orders that quashed the subpoenas; and counseling an investor in a company in connection with litigation in which the shareholder plaintiffs alleged that the company's directors breached their fiduciary duties by entering into a merger agreement that resulted in an acquisition of the company, and various investors aided and abetted those violations and were unjustly enriched. Jen has also represented funds in connection with disputes arising from an investment in a company that sought Chapter 11 protection, and hedge fund traders in joint SEC, CFTC and FERC investigations in which no action was taken against the traders.

Recognized as a "Rising Star" by *New York Super Lawyers*, Jen is also the recipient of the Lisa Beth Deutsch Pro Bono Award and a member of the New York State Bar. She is the co-author of "Federal and State Regulators Target Compliance Officers" in *The Banking Law Journal* and has written on recent developments in Delaware business and securities law in *Computer Law Reporter, Inc.* She contributed to the article "Corporate Cooperation," published in the *National Law Journal*, which was the winner of a Burton Award for Distinguished Legal Writing.

Jen holds a J.D., *magna cum laude*, from the University of Minnesota Law School, where she was Order of the Coif, and a B.A., *summa cum laude*, from Hillsdale College, where she was awarded departmental honors in philosophy. After law school, she clerked for a federal district court judge in Minnesota.

Navigating Risks in the New Enforcement Environment

I. Inter-Relationship Between SEC Examinations and Enforcement Actions, As Well As Between Civil and Criminal Liability

A. Cooperation Between the Securities and Exchange Commission's Office of Compliance Inspections and Examinations ("OCIE") and the Enforcement Division: Following the investigation and prosecution of Bernard Madoff's $17.3-billion Ponzi scheme, the SEC modified the National Exam Program ("NEP") run by OCIE.

1. This has led to increased cooperation between OCIE and staff members from the Division of Enforcement when conducting inspections and examinations, as well as an increase in enforcement actions resulting from OCIE examinations.

2. As a result of this increased cooperation, more and more OCIE examinations include someone from the Enforcement Division as part of the staff conducting an OCIE examination. The mere fact that members of the Enforcement Division participate in a firm's examination does not necessarily mean that the examination will result in a referral to the Enforcement Division, but it does increase the possibility that that will happen.

3. The SEC's approach to enforcement has been increasingly aggressive. After a record-breaking 2014 in which the SEC filed 755 enforcement actions and recovered $4.16 billion in disgorgement and penalties, the Commission managed to go even further the following year, bringing 807 enforcement actions and recovering approximately $4.19 billion by the end of fiscal year 2015.

4. Particularly for hedge funds and private equity funds, since the creation of the Enforcement Division's Asset Management Unit, there has been an emphasis on increasing examiner expertise in those industries,[1] and OCIE has increased its focus on investment advisers of all varieties.[2]

5. Fund managers need to be prepared and should expect that their policies, procedures and practices will be scrutinized carefully during OCIE examinations.[3]

6. Increased cooperation between OCIE and the Division of Enforcement has meant that violations that may have previously been ignored as immaterial may now result in deficiency letters and that matters which previously were the subject of deficiency letters might result in an investigation by the Enforcement Division and/or an enforcement action.

B. Potential Exposure to Criminal Liability/Cooperation Between the SEC and Criminal Prosecutors

1. Regulators have adopted increasingly prosecutorial mindsets in an effort to drive their respective Enforcement Divisions in a more aggressive direction. This has been accomplished by hiring an increased number of former prosecutors into enforcement roles.[4]

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[1] Hazel Bradford, "SEC Management Enforcement Unit Evolves into Respected Watchdog," *Pensions & Investments* (Nov. 30, 2015), *available at* www.pionline.com/article/20151130/PRINT/311309984/sec-management-enforcement-unit-evolves-into-respected-watchdog.

[2] National Examination Program: Office of Compliance Inspections and Examination, *Examination Priorities for 2015*, Securities and Exchange Commission (2015).

[3] Marc E. Elovitz, "SEC Examinations of Private Fund Advisers," *The Review of Securities & Commodities Regulation* (June 17, 2015), *available at* www.srz.com/files/News/4d8f612d-6b91-4ce0-9fa3-fa16b9d51770/Presentation/NewsAttachment/f29ce315-5f8c-44e2-b7bf-006192c396e8/The_Review_of_Securities_and_Commodities_Regulation_SEC_Examinations_of_Private_Fund_Advisers_Jul.pdf.

2. The current Directors of Enforcement at both the SEC and the CFTC are former federal prosecutors, and an increasing number of senior enforcement lawyers at both agencies have backgrounds as criminal prosecutors.

3. Increasingly, financial regulators and prosecutors are cooperating with each other for the purpose of building stronger cases against white collar defendants. The Department of Justice notes that as many cases now feature parallel proceedings (criminal and regulatory) and/or the presence of multi-agency task forces, prosecution teams have expanded accordingly to facilitate cooperation with these regulators.[5]

4. These developments force potential defendants to reconsider whether to cooperate with regulators in exchange for reduced penalties, as such cooperation can lead to eventual criminal charges down the road.

II. Enforcement by the CFTC and Commodities and Futures Exchanges

A. Enforcement by the CFTC

1. The CFTC brought 69 enforcement actions and collected $3.14 billion in civil penalties in fiscal year 2015. This is the largest amount the CFTC has collected in its history and is not far behind the amount collected by the much larger SEC.[6]

2. The CFTC has adopted a more aggressively prosecutorial stance, bringing in a former federal prosecutor to serve as head of its Enforcement Division last year.[7]

B. Recent Major Enforcement of Commodities Laws and Regulations

1. Michael Coscia: Coscia was prosecuted criminally and convicted for entering orders that he had no intention to execute (i.e., spoofing) for the purpose of impacting commodities prices. Coscia took advantage of these price fluctuations in order to generate a profit; using this strategy he earned $1.4 million in less than three months.[8] This case was jointly investigated and litigated by the U.S. Attorney's Office and the CFTC.

2. Navinder Singh Sarao and Nav Sarao Futures Limited PLC: The CFTC has charged Sarao and his firm with spoofing and unlawful manipulation of commodities markets. According to the CFTC's complaint, Sarao's firm was layering large sell orders at different price levels, ensuring that they were seen by other traders, and then canceling the trades. The CFTC is seeking disgorgement, civil penalties, and a trading suspension or ban against Sarao.[9]

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[4] Aruna Viswanatha and Christopher Matthews, "Regulators Tap Prosecutors for Key Jobs," *The Wall Street Journal* (April 6, 2015), *available at* www.wsj.com/articles/regulators-tap-prosecutors-for-key-jobs-1428361038.

[5] David Ogden, *Guidance for Prosecutors Regarding Criminal Discovery*, Department of Justice (Jan. 4, 2010), *available at* www.justice.gov/dag/memorandum-department-prosecutors.

[6] Press Release, Commodities Futures Trading Commission, CFTC Releases Annual Enforcement Results for Fiscal Year 2015 (Nov. 6, 2015), *available at* www.cftc.gov/PressRoom/PressReleases/pr7274-15.

[7] Ben Protess, "Commodities Regulator Names New Enforcement Chief," *The New York Times* (June 10, 2014), *available at* http://dealbook.nytimes.com/2014/06/10/c-f-t-c-hires-new-enforcement-director/?_r=0.

[8] "US High Frequency Trader Convicted in First US Spoofing Case," *The Guardian* (Nov. 4, 2015), *available at* www.theguardian.com/us-news/2015/nov/04/us-high-frequency-trader-convicted-first-spoofing-case-michael-coscia.

[9] Press Release, Commodity Futures Trading Commission, CFTC Charges U.K. Resident Navinder Singh Sarao and His Company Nav Sarao Futures Limited PLC with Price Manipulation and Spoofing (April 21, 2015), *available at* www.cftc.gov/PressRoom/PressReleases/pr7156-15.

3. Arya Motazedi: In the first-ever insider-trading case brought by the CFTC, the Commission found that Motazedi had misappropriated material, nonpublic information for the purpose of making fraudulent transactions between his employer and an account he owned. These trades, which involved oil and gas futures, were designed to generate profits for himself and losses for his employer.[10]

C. Enforcement by Commodities and Futures Exchanges

1. Between April 1, 2012 and March 31, 2013 (the last period reviewed by the CFTC), the Commodities and Futures Exchanges (which include the Chicago Board of Trade (CBOT), Chicago Mercantile Exchange (CME), the Commodity Exchange, Inc. (COMEX) and the New York Mercantile Exchange (NYMEX), collectively referred to as "the Exchanges") brought 93 enforcement actions in their capacity as self-regulatory organizations ("SROs").[11]

(a) During this period, the Exchanges assessed a total of $6.3 million in fines (ranging from $5,000 to $1 million), and $2,023,900 in disgorgement (ranging from $6,000 to $1.1 million).[12]

(b) Additionally, the Exchanges issued suspensions for 51 individuals (ranging from five days to 25 years), and imposed permanent bars on membership against 10 respondents.[13]

(c) The Exchanges have focused their enforcement efforts on highly technical rule violations:

(i) Exchange for Related Positions ("EFRP"): EFRP transactions allow investors to exchange futures contracts for their related physical instruments, derivative positions or options (or other OTC contracts with similar characteristics).[14]

(1) The rules governing the circumstances in which EFRPs are permissible are highly technical and have recently been the focus of regulatory action by the Exchanges. The Exchanges often refer to these rules as essentially imposing strict liability.

(2) Toronto Dominion Bank ("TD"): In a settlement between TD and NYMEX, TD neither admitted nor denied a violation of NYMEX Rule 538.C.[15] TD was alleged to have entered into an EFRP which did not involve the transfer of the cash commodity underlying the Exchange contract, or a by-product, related product or OTC instrument, between TD and its counterparty.[16] TD paid a fine of $15,000.[17]

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[10] Arya Motazedi, CFTC Docket No. 16-02 (Dec. 2, 2015).

[11] U.S. Commodities Futures Trading Commission, Division of Market Oversight, *Disciplinary Program Rule Enforcement Review of the CBOT, CME, COMEX, and NYMEX* (Nov. 21, 2014), *available at* www.cftc.gov/idc/groups/public/@iodcms/documents/file/rerdisciplinaryprogram112114.pdf.

[12] *Id.*

[13] *Id.*

[14] CME Group, *Exchange for Related Positions ("EFRPs")*, *available at* www.cmegroup.com/clearing/trading-practices/efp-efr-eoo-trades.html.

[15] Notice of Disciplinary Action – Toronto Dominion Bank, NYMEX 15-0130-BC-2 (Nov. 25, 2015), *available at* www.cmegroup.com/tools-information/lookups/advisories/disciplinary/NYMEX-15-0130-BC-2-TORONTO-DOMINION-BANK.html.

[16] *Id.*

[17] *Id.*

(ii) Position Limit Violations: CME Rule 562 stipulates, "Any positions … in excess of those permitted under the rules of the Exchange shall be deemed position limit violations."[18]

Pacific Investment Management Company LLC ("PIMCO"): In a settlement agreement between PIMCO and CBOT, PIMCO neither admitted nor denied a violation of CBOT Rule 562.[19] PIMCO was alleged to have violated Rule 562 by having held end-of-day net short positions in excess of both single-month and all-month position limits.[20] PIMCO paid a fine of $35,000.[21]

(d) The CFTC's most recent review found that the Exchanges' practice of sending warning letters was effective for the purpose of deterring violations and that the Exchanges had a reasonable basis for bringing all 93 of the enforcement actions that they filed. However, the CFTC also found that staffing shortages at the Exchanges led to several matters not being enforced promptly.[22]

III. Conflicts of Interest: Recent Enforcement Actions

A. BlackRock Advisors LLC (April 2015)

1. In a settlement with the SEC, BlackRock agreed to pay $12 million and to engage an independent compliance consultant to conduct an internal review for failing to disclose a conflict of interest created by the outside business activity of a top-performing portfolio manager.[23]

2. According to the SEC, the portfolio manager at issue was also the founder of, and a general partner and investor (in the sum of approximately $50 million) in an outside fund participating in a joint venture that eventually became the largest holding in a BlackRock fund.[24]

3. Also according to the SEC, BlackRock knew and approved the portfolio manager's investment and involvement with Rice Energy as well as the joint venture, but failed to disclose the conflict of interest to either the boards of the BlackRock registered funds or its advisory clients.

4. Significantly, BlackRock's then-chief compliance officer ("CCO") agreed to pay a $60,000 penalty to settle the charges against him, which included failure to report a material compliance matter to the funds' boards of directors and causing a failure to adopt and implement policies and procedures for outside activities of employees.[25]

B. Guggenheim Partners Investment Management LLC (August 2015)

1. Guggenheim paid $20 million to the SEC to settle, among other things, charges that it breached its fiduciary duty to disclose a $50-million loan that one of its senior executives received from an

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[18] CME Rulebook, *562. Position Limit Violations*, *available at* www.cmegroup.com/rulebook/CME/I/5/5.pdf.

[19] Notice of Disciplinary Action – Pacific Investment Management Company LLC, CBOT 14-0035-BC (July 24, 2015), *available at* www.cmegroup.com/tools-information/lookups/advisories/disciplinary/CBOT-14-0035-BC-PACIFI-INVESTMENT-MANAGEMENT-COMPANY-LLC.html.

[20] *Id.*

[21] *Id.*

[22] *Id.*

[23] BlackRock Advisors, LLC and Bartholomew A. Battista, Investment Advisers Act Release No. 4065 (April 20, 2015).

[24] *Id.*

[25] *Id.*

advisory client, which the SEC alleged created a potential conflict of interest that might cause Guggenheim to place that client's interests over those of other clients.[26]

2. According to the SEC, after the executive received the loan, the executive then facilitated the investment by the client that issued the loan to him into certain transactions. Later, the same executive facilitated an investment into the same transactions by other Guggenheim clients, which received different terms than the client that had made the loan had received.[27]

3. On these facts, the SEC alleged, among other things, that the failure to disclose the existence of the loan to its other clients was a breach of Guggenheim's fiduciary duties to its clients.[28]

C. JP Morgan Chase Bank N.A. and J.P. Morgan Securities LLC (December 2015)

1. JP Morgan Chase Bank N.A. and J.P. Morgan Securities LLC ("JPM") agreed to pay a total of $307 million to settle charges by the SEC[29] and CFTC[30] that JPM failed to disclose conflicts of interest relating to preferences for (i) JP Morgan-managed mutual funds, (ii) JP Morgan-managed private hedge funds, and (iii) third-party-managed private hedge funds that shared client fees with a JP Morgan affiliate.

2. As part of the settlement, JPM paid $267 million to the SEC[31] and $40 million to the CFTC[32] and had to admit the SEC's factual allegations.

IV. Expense and Fee Allocations

A. "By far the most common deficiencies noted by our examiners in private equity relate to expenses and expense allocation. Many managers still seem to take the position that if investors have not yet discovered and objected to their expense allocation methodology, then it must be legitimate and consistent with their fiduciary duty … . This practice can be difficult for investors to detect but easy for our examiners to test," said Marc Wyatt, director of OCIE.[33]

B. Kohlberg Kravis Robert & Co. ("KKR"): The SEC entered into a settlement with KKR, alleging that KKR charged its clients approximately $338 million in fees over a six-year period related to broken deal or diligence expenses.[34]

1. The SEC alleged that KKR had not been allocating these expenses to co-investors (including some of the firm's executives) and had failed to disclose this practice.[35]

2. KKR agreed to pay over $14 million in disgorgement and a $10-million penalty.[36]

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[26] Guggenheim Partners Investment Management, LLC, Investment Advisers Act of 1940 Release No. 4163 (Aug. 10, 2015).

[27] *Id.*

[28] *Id.*

[29] JPMorgan Chase Bank, N.A. and J.P. Morgan Securities LLC, Investment Advisers Act of 1940 Release No. 4295 (Dec. 18, 2015).

[30] JPMorgan Chase Bank, N.A., CFTC Docket No. 16-05 (Dec. 18, 2015).

[31] JPMorgan Chase Bank, N.A. and J.P. Morgan Securities LLC, Investment Advisers Act of 1940 Release No. 4295 (Dec. 18, 2015).

[32] JPMorgan Chase Bank, N.A., CFTC Docket No. 16-05 (Dec. 18, 2015).

[33] Securities and Exchange Commission, Private Equity: A Look Back and a Glimpse Ahead (May 13, 2015), *available at* www.sec.gov/news/speech/private-equity-look-back-and-glimpse-ahead.html.

[34] Securities and Exchange Commission, SEC Charges KKR with Misallocating Broken Deal Expenses, Release No. 2015-131 (2015).

[35] *Id.*

3. "This is the first SEC case to charge a private equity adviser with misallocating broken deal expenses," said Andrew Ceresney, director of the SEC Division of Enforcement.[37]

C. The Blackstone Group: The SEC charged Blackstone with failing to disclose the acceleration of monitoring fees paid by fund-owned portfolio companies prior to their sale or initial public offering. The SEC alleged that these accelerating fees had the effect of reducing the value of the portfolio companies prior to their sale.[38] The SEC's investigation also found that Blackstone had failed to disclose to investors the existence of a separate fee arrangement with an outside law firm that provided Blackstone with a much greater discount than the same law firm provided to the relevant funds.[39]

1. Blackstone agreed to pay over $26 million in disgorgement and a $10-million penalty in order to settle the charges.[40]

2. "Full transparency of fees and conflicts of interest is critical in the private equity industry and we will continue taking action against advisers that do not adequately disclose their fees and expenses, as Blackstone did here," said Andrew Ceresney, director of the SEC Division of Enforcement.[41]

V. Individual Responsibility

A. Chief Compliance Officer Liability

1. In a series of recent actions, the SEC has sought to hold CCOs liable for compliance failures at their firms. This has caused concern — including a public dissent from approval of two settlements by an SEC Commissioner who subsequently left the Commission[42] — as the claim in these cases is that the CCO failed to implement an effective compliance program despite the fact that the relevant SEC Rule places that obligation to "implement" an effective compliance program on the investment adviser and not on the CCO.[43]

2. Recent Enforcement Actions Against CCOs

(a) BlackRock Advisors Inc. and Bartholomew Battista

(i) One of BlackRock's portfolio managers was also engaged in managing an outside fund. This fund engaged in a joint venture, which BlackRock then had several clients invest in without disclosing the interest that its portfolio manager had in the venture.[44]

(ii) The SEC alleged that this conflict of interest occurred because BlackRock failed to have adequate compliance policies in place, and that Bartholomew Battista, its CCO, was

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[36] *Id.*

[37] *Id.*

[38] Securities and Exchange Commission, Blackstone Charged with Disclosure Failures, Release No. 2015-235 (2015).

[39] *Id.*

[40] *Id.*

[41] *Id.*

[42] Commissioner Daniel M. Gallagher, Securities and Exchange Commission, Statement on Recent SEC Settlements Charging Chief Compliance Officers with Violations of Investment Advisers Act Rule 206(4)-7 (June 18, 2015), *available at* www.sec.gov/news/statement/sec-cco-settlements-iaa-rule-206-4-7.html.

[43] Ben DiPietro, "SEC Actions Stir Concerns over Compliance Officer Liability," *The Wall Street Journal* (June 24, 2015), *available at* http://blogs.wsj.com/riskandcompliance/2015/06/24/sec-actions-stir-concerns-over-compliance-officer-liability/.

[44] BlackRock Advisors, LLC and Bartholomew A. Battista, Investment Advisers Act Release No. 4065 (April 20, 2015).

responsible for this failure. The Commission's view was driven by the fact that Battista knew about the outside activity of several BlackRock managers and still allegedly failed to implement compliance policies designed to monitor and disclose this activity.[45]

(iii) Part of the SEC's criticism of Battista was a claim that BlackRock's compliance procedures were too generic and were not specifically tailored to the actual conflict that arose.

(b) SFX Financial Management Enterprises Inc. and Eugene Mason

(i) An SFX executive was found to have misappropriated client funds by writing checks from their bank accounts to himself over a period of eight years, during which he served as a vice president of SFX and then as its president. When SFX's CCO, Eugene Mason, discovered this, the firm hired outside counsel, conducted an internal investigation, terminated the firm's then-president and reported his misconduct to prosecutors. SFX then cooperated in the ensuing criminal prosecution of its former president.[46]

(ii) In spite of efforts by SFX, and Mason in his capacity as CCO, to work with criminal authorities, the SEC alleged that Mason was responsible for the implementation of SFX's policies and procedures and had failed in this task.[47] Specifically, the Commission alleged that Mason did not effectively implement a provision of SFX's compliance policy providing for the review of cash flows in client accounts; the SEC viewed this as particularly troubling because SFX's Form ADV stipulated that such review was to be done by senior management.[48] The SEC was also troubled by what it alleged was Mason's failure to conduct an annual review of SFX's compliance program (in spite of the fact that this review was delayed because SFX, and Mason particularly, were actively involved in an internal investigation relating to the misappropriation at issue).[49]

(c) In a noteworthy written dissent regarding both the BlackRock and SFX settlements, SEC Commissioner Daniel Gallagher (who resigned from the Commission towards the end of last year) expressed concern that the SEC had effectively taken the position that CCOs are strictly liable for the failure to implement their firms' compliance policies and procedures.[50]

(i) Commissioner Gallagher was concerned that these recent settlements were "undoubtedly sending a troubling message that CCOs should not take ownership of their firm's compliance policies and procedures, lest they be held accountable for conduct that, under Rule 206(4)-7, is the responsibility of the adviser itself. Or worse, that CCOs should opt for less comprehensive policies and procedures with fewer specified compliance duties and responsibilities to avoid liability when the government plays Monday morning quarterback."[51]

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[45] *Id.*

[46] SFX Financial Advisory Management Enterprises, Inc. and Eugene S. Mason, Investment Advisers Act Release No. 4116 (June 15, 2015).

[47] *Id.*

[48] *Id.*

[49] *Id.*

[50] Commissioner Daniel M. Gallagher, Securities and Exchange Commission, Statement on Recent SEC Settlements Charging Chief Compliance Officers with Violations of Investment Advisers Act Rule 206(4)-7 (June 18, 2015), *available at* www.sec.gov/news/statement/sec-cco-settlements-iaa-rule-206-4-7.html.

[51] *Id.*

(ii) In response, the SEC has sought to reassure the compliance community in the wake of these cases, noting that it continues to bring an extremely small number of enforcement actions against CCOs and that the vast majority of these cases involve CCOs who "wore more than one hat," or were otherwise personally involved in the misconduct.[52]

(d) Sands Brothers Asset Management LLC and Christopher Kelly

(i) In October 2014, the SEC instituted cease-and-desist proceedings against Sands Brothers and its CCO, Christopher Kelly, for an alleged violation of Section 206(4)-2 of the Advisers Act and Rule 206(4)-2 thereunder.[53]

(ii) Sands Brothers had consented to a settlement of cease-and-desist proceedings brought against the firm in 2010 related to an earlier alleged violation of Rule 206(4)-2.[54] The SEC alleged that the firm had continued to fail to comply with the rule by failing to distribute audited financial statements to 10 funds within a 120-day window, imposed by the rule, at the end of each fiscal year.[55]

(iii) The SEC further alleged that Kelly, as CCO (but also serving as chief operating officer and as a partner of Sands Brothers), knew or was reckless in not knowing of, and substantially assisted, Sands Brothers' violations of Rule 206(4)-2. As such, the SEC alleged that Kelly had willfully aided and abetted Sands Brothers' in its alleged violations of Section 206(4)-2 and Rule 206(4)-2.[56]

(iv) While acknowledging that Kelly "reminded people of the custody rule deadline,"[57] the SEC alleged that more substantial action was required of Kelly as CCO. Specifically, the SEC alleged that because Sands Brothers' compliance manual tasked Kelly with "ensuring compliance with … Rule 206(4)-2," and because such compliance was not occurring, Kelly had failed to implement policies or procedures to ensure compliance with the rule.[58]

B. The Yates Memo

1. This memo broadly outlines the intent of the DOJ to increase its focus on bringing criminal charges against individuals bearing responsibility for corporate misconduct.[59]

The memo makes clear that its guidance should also be taken into consideration by regulators responsible for bringing civil actions in response to allegations of corporate misconduct, but the memo only applies to the DOJ and not to the SEC, CFTC or other regulators.[60]

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52 Commissioner Luis A. Aguilar, Securities and Exchange Commission, The Role of Chief Compliance Officers Must Be Supported (June 29, 2015), *available at* www.sec.gov/news/statement/supporting-role-of-chief-compliance-officers.html. Like Commissioner Gallagher, Commissioner Aguilar also resigned from the Commission at the end of last year.

53 Sands Brothers Asset Management, LLC, Steven Sands, Martin Sands, and Christopher Kelly, Investment Advisers Act Release No. 3960 (Oct. 29, 2014).

54 *Id.*

55 *Id.*

56 *Id.*

57 *Id.*

58 *Id.*

59 Sally Quillian Yates, Department of Justice, *Individual Accountability for Corporate Wrongdoing* (Sept. 9, 2015).

60 *Id.* at 2-3, 6.

2. Recommendations for Corporations

   (a) Provide all relevant facts regarding individual involvement in corporate misconduct.[61] The Yates memo takes the position that corporations must turn over absolutely all evidence related to individual misconduct, and corporations may not pick and choose what to turn over, before they will be considered for any kind of cooperation credit.

   (b) Focus on individual wrongdoing from the outset of an investigation.

   (c) Increase cooperation between criminal and civil attorneys. The goal is that increased dialogue between criminal and civil government attorneys would lead to more thorough investigations and a full range of potentially viable claims being brought against alleged wrongdoers.[62]

   (d) Settlements with corporations should not release alleged individual wrongdoers from liability.[63]

   (e) Always resolve cases of corporate misconduct with a plan to deal with allegedly culpable individuals before the relevant statute of limitations expires.

   (f) Civil attorneys for the government should also focus on individuals and look beyond a party's ability to pay a judgment when considering whether to bring suit.[64]

VI. Insider Trading Post-*Newman*

A. Significance of *U.S. v. Newman*

1. In *Newman*, the U.S. Court of Appeals for the Second Circuit reversed two insider-trading convictions, finding that the government had not sufficiently proved that the defendants had been aware that the insiders responsible for passing on information had done so in exchange for a personal benefit and thus in violation of their fiduciary duties.[65]

2. The *Newman* court also held that the government had failed to adequately prove that the insiders obtained a personal benefit that was sufficiently concrete and of a pecuniary or pecuniary-like nature, finding that such a benefit is an essential element of a breach of fiduciary duty by the insider necessary to give rise to insider-trading liability.[66]

   (a) The government had argued that the receipt of career advice by the tipper qualified as a personal benefit given in exchange for the tip at issue, but the Second Circuit rejected that this was sufficient to allow a rational fact finder to conclude beyond a reasonable doubt that a personal benefit that was sufficiently concrete and pecuniary in nature had been given in exchange for the tip.[67]

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[61] *Id.* at 3.

[62] *Id.* at 4-5.

[63] *Id.* at 5.

[64] *Id.* at 6-7.

[65] *United States v. Newman*, 773 F.3d 438, 450-51 (2nd Cir. 2014).

[66] *Id.* at 452-53.

[67] *Id.* at 452.

(b) In rejecting the government's argument, the Second Circuit held: "To the extent *Dirks* suggests that a personal benefit may be inferred from a personal relationship between the tipper and tippee, where the tippee's trades 'resemble trading by the insider himself followed by a gift of the profits to the recipient,' … we hold that such an inference is impermissible in the absence of proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."[68]

(c) The court did not clarify what types of personal benefit would satisfy this test, leaving it to future case-by-case evaluation by the courts. It did note, however, that entrance to an investment club, receiving client referrals, or entering into commission-splitting arrangements in exchange for a tip would suffice.[69]

B. Insider-Trading Decisions after *Newman*

1. It must be emphasized that *Newman*'s reach is limited to the Second Circuit (which consists of federal courts sitting in New York, Connecticut and Vermont). Several courts outside the Second Circuit have already decided not to follow *Newman*.

(a) *U.S. v. Salman*: The Ninth Circuit declined to follow *Newman*, holding that the U.S. Supreme Court's insider-trading jurisprudence had established that liability for a tippee could be established when an "insider makes a gift of confidential information to a trading relative or friend."[70]

(i) Of particular importance in *Salman* was the close familial relationship between the tipper and tippee (they were brothers); the tipper testified that he had given his brother information in order to "benefit him" and to "fulfill whatever needs he had."[71] In one instance, the tipper gave the tippee information in lieu of a loan.[72]

(ii) The defendant in *Salman* was the brother-in-law of the tipper and tippee, and the court found that he was aware of both the source of the tip as well as the close fraternal relationship between the tipper and tippee.[73]

(b) *U.S. v. Melvin*: A Georgia federal district court declined to follow *Newman*, noting that it was not binding authority. In rejecting the holding of *Newman*, the *Melvin* court focused on both the gift language of the U.S. Supreme Court's decision in *Dirks* in addition to the fact that pecuniary gain is not necessary to prove a personal benefit.[74]

(i) The *Melvin* court found that the defendant had a close personal friendship with those to whom he had provided confidential inside information.[75]

[68] *Id.*

[69] *Id.* at 453-54.

[70] 792 F.3d 1087, 1093-94 (9th Cir. 2015) (citing *Dirks v. SEC*, 463 U.S. 646, 664 (1983)).

[71] *Id.* at 1089.

[72] *Id.*

[73] *Id.* at 1090.

[74] 2015 WL 7077258, at *15 (N.D. Ga. 2015).

[75] *Id.* at *1.

(ii) Important to the court's analysis was that the U.S. Court of Appeals for the Eleventh Circuit "has interpreted [*Dirks*] to define '"benefit" in very expansive terms,' indicating that in *Dirks*, 'the Court declared that not only does an actual pecuniary gain, such as a kickback or an expectation of a reciprocal tip in the future, suffice to create a "benefit," but also cases where the tipper sought to enhance his reputation (which would translate into future earnings) or to make a gift to a trading relative or friend.'"[76]

(c) It is also worth noting that the SEC's own administrative courts — in which the SEC has brought an increasing number of enforcement actions in recent years — are not bound by *Newman*.

VII. Anti-Money Laundering Rules, Cases and Implications for Fund Managers

A. Proposed FinCEN Rulemaking

1. On Sept. 1, 2015, the Financial Crimes Enforcement Network ("FinCEN") issued a notice of proposed rulemaking to prescribe, among other things, minimum standards for anti-money laundering ("AML") programs to be established by registered investment advisers. The proposed rule would also require the registered investment advisers to report suspicious transactions that are conducted or attempted by, at or through an investment adviser, and involve or aggregate at least $5,000 in funds or assets.[77]

(a) The proposed rule would apply to investment advisers who are registered or required to be registered with the SEC.

(b) AML programs must include:

(i) Development of internal policies, procedures and controls reasonably designed to prevent the investment adviser from being used for money laundering or the financing of terrorist activities, and to achieve and monitor compliance with the BSA and FinCEN's implementing regulations.

(ii) The designation of an AML compliance officer. This person should be an officer of the investment adviser.

(iii) An ongoing employee training program.

(iv) An independent audit function to test the programs.

(c) Under the proposed rule, investment advisers may contractually delegate some duties of their compliance program to other entities, including agents or third-party service providers, such as administrators. However, any entity that does so will remain fully responsible for the effectiveness of the program, as well as for ensuring that FinCEN and the SEC are able to obtain information and records relating to the AML program.

(d) The SEC will act as the designated examiner of investment advisers for compliance with the rules.

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[76] *Id.* at *15 (quoting *SEC v. Yun*, 327 F.3d 1263, 1276 (11th Cir. 2003)).

[77] Anti-Money Laundering Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers, 80 Fed. Reg. 169 (proposed Sept. 1, 2015) (to be codified at 31 C.F.R. Ch. X).

B. Recent AML Enforcement Actions

1. Oppenheimer (January 2015)

(a) The SEC charged Oppenheimer with, among other things, aiding and abetting illegal unregistered broker-dealer activity by a customer, an off-shore broker-dealer.

(b) According to the settlement document, Oppenheimer knew, suspected or had reason to suspect that one of its clients was using its Oppenheimer account to facilitate unlawful activity, but did not file Suspicious Activity Reports ("SARs").

(c) Oppenheimer agreed to admit wrongdoing and pay $10 million to settle the SEC's charges[78] and an additional $10 million to settle a parallel action by FinCEN.[79] Oppenheimer also agreed to retain an independent compliance consultant.

2. First National Community Bank (February 2015)

(a) FinCEN assessed a civil money penalty against First National Community Bank ("FNCB") for violations of the Bank Secrecy Act ("BSA"), and FNCB admitted such violations.

(b) According to the Assessment of Civil Money Penalty, FNCB failed to "detect or adequately report suspicious transactions involving millions of dollars in illicit proceeds from a judicial corruption scheme perpetrated by a former Pennsylvania state judge, among others."[80]

(c) FNCB agreed to pay a penalty of $1.5 million, of which $500,000 was concurrent with a penalty imposed by the Office of the Comptroller of the Currency. In connection with the settlement, FinCEN expressly reserved the right to bring claims against parties other than FNCB, including any current or former partner, director, officer or employee of FNCB.[81]

3. Commerzbank (March 2015)

(a) Commerzbank entered into a Deferred Prosecution Agreement with the DOJ, as well as settlements with OFAC and the Federal Reserve.[82] Commerzbank paid $563 million in disgorgement and $79 million in penalties.[83] It paid $300 million in forfeiture in connection with BSA violations. In total, Commerzbank agreed to pay a total of $1.45 billion in penalties.

(b) The DOJ alleged that one of its clients used Commerzbank to perpetuate a massive accounting fraud designed to conceal from the clients' auditors and investors hundreds of millions of dollars in losses from the late 1990s to 2011, and that Commerzbank had failed to thoroughly conduct investigations of transactions that triggered alerts in the bank's automated AML software. Moreover, the bank failed to report this suspicious activity to regulators and failed to monitor billions of dollars in correspondent banking transactions.[84]

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78 Oppenheimer & Co. Inc., Securities Act Release No. 9711 (Jan. 27, 2015).

79 Oppenheimer & Co., Inc., FinCEN No. 2015-01 (Jan. 26, 2015).

80 First National Community Bank Dunmore Pennsylvania, FinCEN No. 2015-03 at *2 (Feb. 27, 2015).

81 *Id.*

82 *United States v. Commerzbank*, Deferred Prosecution Agreement (March 11, 2015).

83 *Id.*

84 *Id.*

(c) Recent actions to enforce AML laws and regulations make it clear that simply having a compliance program in place is not sufficient. Among other things, regulators expect firms to have procedures in place that take into account the particular risks presented by the firm's business activities, and to have qualified AML officers. It is likely that investment advisers will find themselves subjected to these same requirements in the near future.

4. LPL Financial LLC (May 2015)

(a) In May 2015, LPL Financial LLC ("LPL") and FINRA entered into a Letter of Acceptance, Waiver and Consent ("AWC").[85] According to the AWC, LPL had in place a surveillance system that suffered from coding errors and therefore failed to generate alerts based on risk-based scenarios for customer ATM withdrawals. After the coding error was detected, LPL was unable to correct the coding promptly. According to FINRA, as a result, LPL failed to have a system reasonably designed to monitor for suspicious activity relating to customer ATM use.[86]

(b) In connection with settling these and other allegations, LPL consented to the imposition of a censure and a fine in the amount of $10 million. In addition, in connection with its surveillance system AML scenarios, LPL was required to conduct transactional look-backs for the periods during which the surveillance system was not fully functional.[87]

5. Halcyon Cabot Partners Ltd. (October 2015)

(a) In July 2015, FINRA filed a disciplinary proceeding against Halcyon Cabot Partners, Ltd. ("HCP"), Michael Trent Morris and Ronald Mark Heineman. On Oct. 6, 2015, FINRA entered an order accepting an offer of settlement from HCP, as well as Morris and Heineman, who were the firm's CCOs and AML officers during the relevant period.[88]

(b) FINRA alleged, among other things, that between 2010 and 2013, HCP, Morris and Heineman engaged in a scheme to defraud investors by causing HCP to serve as a bogus placement agent to conceal a kickback of a private placement fee, and caused the firm to serve as a false sales agent so that a now-expelled broker-dealer could charge commissions to both buyers and sellers in certain private sales of securities.[89]

(c) FINRA claimed that these and other violations were enabled by HCP's culture of non-compliance, which manifested itself in numerous supervisory violations and an inoperable AML program. Specifically, with respect to the AML program, FINRA alleged, among other things, that: (i) HCP had inadequate supervisory procedures because those procedures did not accurately reflected the risks posed by HCP's business model and the controls necessary to mitigate those risks; (ii) HCP failed to implement its AML program; (iii) HCP failed to detect and investigate red flags related to potentially suspicious securities transactions; and (iv) HCP did not have a qualified AML officer.[90]

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85 LPL Financial LLC, Letter of Acceptance, Waiver and Consent, No. 2013035109701 (May 6, 2015).

86 *Id.*

87 *Id.*

88 Halcyon Cabot Partners, Ltd., Michael Trent Morris, and Ronald Mark Heineman, FINRA Disciplinary Proceeding No. 2012033877802 (Oct. 6, 2015).

89 *Id.*

90 *Id.*

(d) As a sanction, HCP was expelled from FINRA, and Morris and Heineman were barred from association with any FINRA member in any capacity.[91]

VIII. Whistleblowers Post-*KBR*

A. As part of a settled action, the SEC imposed a cease-and-desist order on engineering company KBR Inc., alleging that the company violated SEC Rule 21F-17 by forcing its employees to sign confidentiality statements related to its internal compliance investigations.[92]

1. Rule 21F-17(a) states: "No person may take any action to impede an individual from communicating directly with the Commission staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement … with respect to such communications."[93]

2. The SEC was not aware of any instance in which a KBR employee either had been prevented from revealing information to federal regulators, or had been subjected to discipline as a result of bringing any matter covered by the confidentiality statement to federal regulators. Nonetheless, the Commission alleged that "the language found in the form confidentiality statement impedes such communications by prohibiting employees from discussing the substance of their interview without clearance from KBR's law department under penalty of disciplinary action including termination of employment."[94]

B. The result of the settlement was that KBR paid a $130,000 fine and, most significantly, agreed to amend its confidentiality statement "to make clear that its current and former employees will not have to fear termination or retribution or seek approval from company lawyers before contacting [the SEC]," according to Sean McKessy of the SEC Office of the Whistleblower.[95] It is likely that the SEC will continue to bring actions against registered employers that have not reformed their confidentiality agreements in line with the SEC's view as expressed in *KBR* of what such confidentiality agreements may and may not contain.

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[91] *Id.*

[92] KBR, Inc., Exchange Act Release No. 74619, 2015 WL 1456619 (April 1, 2015).

[93] 17 C.F.R. § 240.21F-17(a).

[94] KBR, Inc., Exchange Act Release No. 74619, 2015 WL 1456619 (April 1, 2015).

[95] Scott Hingham, "SEC Finds That KBR Confidentiality Agreements 'Stifled' Whistleblowers," *The Washington Post* (April 1, 2015), *available at* www.washingtonpost.com/investigations/sec-finds-that-kbr-confidentiality-agreements-stifled-whistleblowers/2015/04/01/c78f6708-d884-11e4-8103-fa84725dbf9d_story.html.

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Chambers USA, *The Legal 500 United States*, *New York Super Lawyers* and *Tax Directors Handbook* have recognized Philippe as a leading lawyer. He is a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and also speaks at prominent industry events, including PLI's Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances 2015 conferences in New York and San Francisco. He also recently presented on topics including FATCA, customized solutions for investors, and management company structuring and operations.

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Recently named chair of the Private Investment Funds Subcommittee of the International Bar Association, Stephanie is a founding member and former chair of the Private Investment Fund Forum, a member of the Advisory Board of Third Way Capital Markets Initiative, a member of the board of directors of 100 Women in Hedge Funds, a member of the Board of Visitors of Columbia Law School and a member of the board of directors of the Girl Scouts of Greater New York. She is listed in *Chambers USA*, *Chambers Global*, *IFLR1000*, *The Legal 500 United States*, *Best Lawyers in America*, *Who's Who Legal: The International Who's Who of Business Lawyers* (which ranked her one of the world's "Top Ten Private Equity Lawyers"), *Who's Who Legal: The International Who's Who of Private Funds Lawyers* (which ranked her at the top of the world's 2014 "Most Highly Regarded Individuals" list), *Expert Guide to the Best of the Best USA*, *Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers*, *Expert Guide to the World's Leading Women in Business Law* and *PLC Cross-border Private Equity Handbook*, among other leading directories. Stephanie was named the "Private Funds Lawyer of the Year" at the 2014 Who's Who Legal Awards and the Euromoney Legal Media Group's "Best in Investment Funds" at the inaugural Americas Women in Business Law Awards. She is also recognized as one of *The Hedge Fund Journal*'s 50 Leading Women in Hedge Funds and was named one of the 2012 Women of Distinction by the Girl Scouts of Greater New York. She is a much sought-after speaker on fund formation and operation and compliance issues, and she regularly publishes articles on the latest trends in these areas. Stephanie co-authored *Private Equity Funds: Formation and Operation* (Practising Law Institute) and *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press), contributed a chapter on "Hedge Fund Investment in Private Equity" for inclusion in *PLC Cross-border Private Equity Handbook 2005/06* (Practical Law Company) and a chapter on "Advisers to Private Equity Funds — Practical Compliance Considerations" for *Mutual Funds and Exchange Traded Funds Regulation, Volume 2* (Practising Law Institute), and wrote *New York and Delaware Business Entities: Choice, Formation, Operation, Financing and Acquisitions* (West) and *New York Limited Liability Companies: A Guide to Law and Practice* (West).

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A frequent speaker and panelist, Charles has addressing a wide variety of topics of interest to the white collar defense community, including, most recently, the Wells settlement process at the SEC and short-selling violations under Rule 105. He also serves as a resource for numerous media publications, including the *Bloomberg News*, *Financial Times*, *The Wall Street Journal* and *The Washington Post*.

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Brian is well known for his thought leadership in the regulatory and compliance area as it affects alternative investment funds and is a key part of Schulte Roth & Zabel's educational outreach. In addition to hosting SRZ webinars, participating in firm-sponsored seminars and workshops, and authoring SRZ alerts and white papers, he recently published "Q&A with Brian T. Daly: SRZ's Systematic and Quantitative Strategies Practice" in *The Hedge Fund Journal* and "Securities, Futures Regulators Increase Scrutiny, Expectations on Cybersecurity" in *Bloomberg Brief — Financial Regulation*. His recent speaking engagements addressed topics including how U.K. fund managers registered as CPOs or CTAs should prepare for NFA examinations, and hedge fund and management company structures. Brian also teaches legal ethics at Yale Law School, focusing on the challenges faced by in-house counsel. He is a chair of the Steering Committee for the Managed Funds Association's CTA/CPO Forum and a member of the CFTC Working Group for the Alternative Investment Management Association and of the New York City Bar Association's Private Investment Funds Committee. He formerly served as co-chair of the MFA's General Counsel Forum, its CTA, CPO & Futures Committee, and as a steering committee member of its Investment Advisory Committee.

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David is listed in *Chambers Global*, *Chambers USA*, *Expert Guide to the World's Leading Banking*, *Finance and Transactional Law Lawyers*, *The Legal 500 United States* and *Who's Who Legal: The International Who's Who of Private Funds Lawyers*. In particular, *Chambers USA* has noted that David is "an outstanding lawyer, with excellent judgment and the necessary soft touch during the delicate negotiations that occur during a start-up/launch," and clients say "he is attuned to the business considerations and provides measured, reasoned advice that reflects his deep experience and industry knowledge." *The Legal 500 United States* has recognized him as "an extraordinarily capable attorney." A published author on subjects relating to investment management, David recently co-authored *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press). He also is a sought-after speaker for hedge fund industry conferences and seminars, and a frequent guest lecturer at New York-area law and business schools. He most recently presented on current trends with emerging managers in a prime brokerage (consulting services) presentation, and on product and marketing strategies for growth for hedge fund COOs and CFOs.

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Steve is recognized by many ranking publications, including *Chambers Global*, *Chambers USA*, *The Legal 500 United States*, *Expert Guide: Best of the Best* (Investment Funds), *Expert Guide: Best of the Best USA* (Investment Funds), *Expert Guide to the World's Leading Banking*, *Finance and Transactional Law Lawyers*, *International Who's Who of Private Funds Lawyers*, *The Best Lawyers in America* and *New York Super Lawyers*. A past member of the American Bar Association's Committee on Partnership and the New York City Bar Association's Committee on Art Law, Steve is a frequent speaker and writer in his areas of expertise. He most recently presented on ERISA issues for private investment funds and distressed investing issues for structured products. He is a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and "Asset Manager M&A Deals," an SRZ white paper.

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Adam is chair of Schulte Roth & Zabel's Business Reorganization Group and a member of the firm's Executive Committee. He practices in the areas of corporate restructurings, workouts and creditors' rights litigation, with a particular focus on representing investment funds and financial institutions in distressed situations. Adam represents a variety of clients in connection with distressed acquisitions by third-party investors or existing creditors through "credit bid" or similar strategies, as well as in court-supervised and out-of-court restructurings. In addition to representing creditors and acquirers in distressed situations, he has represented Chapter 11 debtors, as well as portfolio companies, in out-of-court exchange offers, debt repurchases and other capital restructurings. His recent representations include advising Cerberus Capital Management LP in connection with the Chapter 11 bankruptcy of RadioShack Corp., Mount Kellett Master Fund II in the Chapter 11 case of The Great Atlantic and Pacific Tea Company (as both lender and equity holder), and a group of private equity funds in the Allied Systems Holdings bankruptcy, in their capacity as first lien lenders, in a successful challenge to the efforts of a private equity sponsor that tried to acquire a controlling interest in the first lien debt.

Numerous ranking publications, including *The Best Lawyers in America*, *Chambers Global*, *Chambers USA*, *The K&A Restructuring Register* and *The Legal 500 United States*, have recognized Adam as a leader in his field. He has co-authored publications addressing cramdown plans, redemption option value, priming DIPs, out-of-court restructurings and proposals to reform Chapter 11. He also contributed to *Distressed Investing M&A* (SRZ in association with Mergermarket and Debtwire), and he co-authored "Health Care Business Restructuring for Secured Lenders," an SRZ guide republished by *Bloomberg BNA – Bankruptcy Law Reporter*. Adam also co-authors the "Out-of-Court Restructurings, the Bankruptcy Context, and Creditors' Committees" chapter in PLI's *Insider Trading Law and Compliance Answer Book*. He presents frequently on topics of concern to the private funds community, including, most recently, interlender arrangements, structuring credit funds, distressed investing in the health care sector, fraudulent conveyance laws and distressed private equity investments.

Adam received his J.D., *magna cum laude*, from Georgetown University Law Center and his B.A. from Emory University.

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Christopher Hilditch

Chris heads Schulte Roth & Zabel's London office, where he advises a wide range of institutional and entrepreneurial managers on structuring and establishing investment funds, particularly hedge funds, funds of hedge funds, co-investment funds and other innovative products. On an ongoing basis, he counsels promoters and managers on operational issues, including prime brokerage arrangements, investment transactions and relations with investors. He also advises on regulatory issues affecting funds and their managers, as well as on corporate, securities and partnership law issues.

Listed as a leading hedge fund lawyer in *Chambers UK*, *The Legal 500 UK*, *PLC Cross-border Investment Funds Handbook*, *The International Who's Who of Private Fund Lawyers* and *Who's Who of Professionals*, Chris is a member of the Legal Experts Group for the Financial Conduct Authority, the Law Society, the City of London Solicitors Company and the International Bar Association, and he has participated in a number of ad hoc industry committees. He is a frequent speaker on hedge funds and related topics and a regular contributor to a variety of industry publications. He co-authored *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) as well as numerous articles. He also contributed to *Investment Management: Law and Practice* (Oxford University Press). At recent speaking engagements, Chris has addressed investor needs and expectations, marketing challenges in the United States and the EU, and AIFMD and other EU regulatory issues.

Chris attended law school at the College of Law, Guildford and graduated with an M.A., with honors, from Oxford University.

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Daniel F. Hunter

Dan concentrates his practice on the design, structure and regulation of alternative investment products, including hedge funds, hybrid funds and private equity funds. He regularly advises funds that invest in distressed debt, asset-backed securities and bank loans. Dan also provides day-to-day regulatory, operational, merger and acquisition, and restructuring advice to his fund clients, and he advises funds regarding the receipt or allocation of seed capital. As part of his compliance practice, he advises clients on the Treasury Forms (TIC Forms) and Bureau of Economic Affairs Forms (BEA Forms).

Dan has been recognized in *The Legal 500 United States* in the Investment Fund Formation and Management and Private Equity Funds categories. A sought-after speaker, he recently presented on topics including the structuring and management of funds, compliance and regulatory issues, and ERISA's impact on private equity and hedge funds. He is a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press), and he has served as a guest lecturer at the New York University School of Continuing and Professional Studies, where he taught "Introduction to Hedge Funds." He also serves on the University of Michigan Honors Alumni Council.

Dan received his J.D. from the University of Michigan Law School and his A.B., *cum laude* and with high honors in history, from the University of Michigan.

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Practices

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Taleah E. Jennings

Taleah's practice focuses on complex commercial litigation of all types. Her clients are primarily financial services entities, such as investment managers, private equity firms, interdealer brokerage firms and commercial real estate firms. Taleah has litigated cases in various state and federal courts, as well as regulatory and arbitration forums, from the commencement of claims through trials and appeals. She has represented a major interdealer brokerage firm in various arbitrations and civil litigations arising out of a global corporate raid by a fierce competitor, a large private equity firm in a case alleging alter ego liability arising out of alleged contractual breaches by a portfolio company, an investment manager in a dispute with a former employee who claimed an ownership interest in millions of dollars of client revenues, and many other clients in complex commercial disputes.

Recognized by *New York Super Lawyers* as a "Rising Star," Taleah is also a New York State Bar Association Empire State Counsel Honoree and a two-time recipient of Sanctuary for Families' Excellence in Pro Bono Advocacy Award. She has published on topics including competitor raids and misappropriation of trade secrets, and is the author of the "Penalties, Short-Swing Profits, and Whistleblower Awards" chapter in the *Insider Trading Law and Compliance Answer Book* (Practising Law Institute). In recent speaking engagements, she has addressed trends in the use of restrictive covenants and trade secrets in employment alternative dispute resolution.

Taleah holds a J.D. from Rutgers-Newark Law School and a B.S. from the University of Maryland.

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Jason S. Kaplan

Jason's practice concentrates on corporate and securities matters for investment managers and alternative investment funds. He represents institutional and entrepreneurial investment managers, financial services firms and private investment funds in all aspects of their business. He advises managers of hedge, private equity and hybrid funds regarding the structure of their businesses and on day-to-day operational, securities, corporate and compliance issues; structures and negotiates seed and strategic investments and relationships and joint ventures; and advises investment managers with respect to regulatory and compliance issues.

Jason has been recognized by both *IFLR1000* and *New York Super Lawyers* as a "Rising Star," and he publishes and speaks often about topics of concern to private investment funds. He is the co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and of "Information Security: Obligations and Expectations," a Schulte Roth & Zabel white paper. In his recent speaking engagements, he has discussed co-investments, considerations for managers in their first five years of operations, and marketing opportunities and challenges for funds.

Jason earned his J.D. from Fordham University School of Law and his B.S. from the University of Michigan.

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John J. Mahon

John primarily represents private equity firms and other financial sector participants in a wide range of capital markets and securities law matters. He regularly assists clients in connection with the establishment and operation of business development companies, registered closed-end funds and other similar public and private vehicles that comply with complex regulatory structures, including the Investment Company Act of 1940, the Investment Advisers Act of 1940 and the Dodd-Frank Act. With more than a decade of experience, John has been involved with more than 100 debt and equity offerings, including over 20 IPOs, reflecting an aggregate of over $10 billion in total proceeds. His work in securities law and mergers and acquisitions includes providing guidance to many New York Stock Exchange and Nasdaq-listed companies in connection with ongoing corporate governance and U.S. Securities and Exchange Commission reporting and compliance matters. John also routinely handles issues involving tender offers, proxy solicitations, going-private transactions and beneficial ownership reporting obligations.

John is a recipient of the SEC Capital Markets Award, and he was named a *Washington, DC Super Lawyers* "Rising Star." He serves as an adjunct professor at The George Washington University Law School and is the former chair of the Corporate Finance Committee of the Corporation, Finance and Securities Law Section of the District of Columbia Bar. He has spoken and written on topics that include SEC regulations and capital-raising, executive compensation disclosure and implications of Rule 144 revisions, and SPACs and M&A issues.

John holds a J.D. from Georgetown University Law Center and a B.S.B.A., *cum laude*, from the University of Richmond, where he was a member of Beta Gamma Sigma.

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Anna Maleva-Otto

Anna concentrates her practice on advising asset managers on a range of U.K. financial services regulatory matters, including the impact of EU directives and regulations. She has advises clients on the establishment of regulated businesses, financial crime (including market abuse, money laundering and bribery), financial promotion and offers of securities, regulatory reporting and disclosure obligations, regulatory capital, and conduct of business rules. Prior to joining Schulte Roth & Zabel, Anna gained substantial experience advising hedge fund managers, brokers, insurance firms and investment banks on a wide spectrum of regulatory matters in her roles in private practice and as an in-house counsel and compliance officer of a hedge fund manager. She frequently participates in industry working groups in connection with new and emerging regulatory initiatives, and has advised asset manager trade associations on their advocacy efforts related to several key pieces of recent EU legislation (including the Short Selling Regulation, Alternative Investment Fund Managers Directive, MiFID II and MAD II). Anna began her career as a regulatory consultant assisting clients in the financial services sector with the design and implementation of compliance procedures, conduct of internal compliance investigations, compliance audits and remediation exercises.

The Legal 500 UK has recognized Anna as a leading lawyer, and she is admitted to practice in England, Wales and New York. She frequently speaks and writes on topics related to her areas of expertise. She recently co-authored “AIFMD Update: ESMA Advice on Extension of Marketing Passport Published” in *The Hedge Fund Journal* and “Marketing Alternative Funds in Europe: A Changed Landscape” in *Risk & Compliance Magazine*, and her recent speaking engagements have addressed topics including trading compliance and CFTC updates, as well as systematic and quantitative strategies for funds.

Anna received her J.D. from Emory University School of Law and her M.A. from Saint Petersburg State University (Russia).

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David Nissenbaum

David's practice focuses on corporate, securities and bank regulatory matters. He primarily represents institutional and entrepreneurial investment managers, financial services firms and private investment funds in all aspects of their businesses. He structures investment management and financial services firms as well as hedge, private equity, credit, distressed investing and hybrid funds, energy funds, co-investments, funds of funds and scalable platforms for fund sponsors. David provides legal and business advice on fund structuring, fundraising, management company partnerships, compensation plans, succession plans, seed and strategic investments and spinoffs of investment teams. His work also includes counseling clients on finding practical solutions to regulatory and compliance requirements, including the Volcker Rule, and managing conflicts of interest with an emphasis on reducing legal risk to the business.

David has been named a leader in his field by *Chambers Global* and *Chambers USA* and has been recognized by *The International Who's Who of Private Funds Lawyers*, *PLC Cross-border Private Equity Handbook*, *The Legal 500 United States* and *Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers*. A member of the Advisory Board of The Financial Executives Alliance and past member of the Banking Law Committee of the New York City Bar Association, David is a sought-after writer and speaker. Works he has authored or co-authored include the chapter "Management Company Structures and Terms" in *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press), "Hedge Fund Names: What a Hedge Fund Manager Should Do Before It Starts Using a Name" in *The Hedge Fund Law Report* and "Just Like Starting Over: A Blueprint for the New Wall Street Firm," published by *The Deal*. He has addressed topics at conferences and seminars including co-investment vehicles, investing in the oil and gas sector, liquidity events, exits and succession planning.

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Eliot focuses his practice on commercial and corporate finance transactions, primarily representing hedge funds, private equity funds, commercial finance companies and investment banks in domestic and cross-border secured and unsecured finance transactions. He regularly handles matters including asset-based and cash flow financings; acquisition and leveraged buyout financings; subordinated and mezzanine financings; first-out/last-out, second lien and tranche B financings; and debtor-in-possession and exit financings. Eliot also counsels clients in debt restructuring and general corporate finance matters, and has recently represented clients in connection with secured loans, credit facilities and acquisition financings for a range of businesses.

Eliot has been recognized by *New York Super Lawyers* as a leader in his field. He has also spoken on topics of interest to the investment management community, including distressed investing in the retail industry and dividend recapitalizations.

Eliot received his J.D. from Hofstra University School of Law and his B.A. from the University of Michigan.

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Ron is co-head of Schulte Roth & Zabel's Employment & Employee Benefits Group, and his practice concentrates on the litigation of employment and employee benefits cases in federal and state courts throughout the United States involving trade secrets, non-competition, non-solicit, and breach of confidentiality and breach of loyalty issues. Ron defends employee benefit plans, fiduciaries, and employers in class actions and in cases brought by individual plaintiffs. He represents employee benefit plans before the U.S. Department of Labor, the Pension Benefit Guaranty Corporation and the Internal Revenue Service in connection with novel issues of law concerning plan mergers, terminations, spinoffs, fiduciary duties and prohibited transactions, and various aspects of withdrawal liability and mass withdrawal liability. He also represents employers (particularly hedge and private equity funds), employees and partners with respect to executive compensation and partnership issues.

Recognized by *New York Super Lawyers* and *The Best Lawyers in America* as a leading labor and employment litigation attorney, Ron is a Fellow of the American College of Employee Benefits Counsel and a member of the CPR Employment Dispute Committee of the CPR Institute for Dispute Resolution. He is a former board member for the Lawyers Alliance for New York, which recognized him in 2015 as a "15 Year Circle" honoree, and a former adjunct professor in the New York University School of Continuing Education's Certified Employee Benefits Specialist Program. Ron frequently speaks and writes on employee benefits and employment topics of interest to the human resources and investment management communities. He most recently presented on recent employee benefits issues for investment managers, ERISA and the impact of the *Dudenhoeffer* case. He is the co-author of "Recent Labor Department Actions Target Independent Contractor Misclassification, Overtime" and "2nd Circuit Adopts New 'Primary Beneficiary' Test for Determining if Unpaid Interns are Employees" in *Westlaw Journal — Employment* and "Now We Know How NYC's Credit Check Ban Will Be Interpreted" in *Law360*.

Ron received his J.D. from Columbia University School of Law, where he was a Harlan Fiske Stone Scholar and the recipient of the Emil Schlesinger Labor Law Prize, and his B.S. from the Industrial and Labor Relations School at Cornell University.

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Paul N. Roth

Paul is a founding partner of Schulte Roth & Zabel and chair of its Investment Management Group. Throughout his career, he has acted as counsel to leading public and private companies in financial services and to their boards of directors. Paul's extensive private investment funds practice, an area in which he has more than 45 years of experience, includes the representation of hedge funds, private equity funds, offshore funds, investment advisers and broker-dealers in connection with fund formations and compliance, securities regulation, mergers and acquisitions (domestic and cross-border) and other financial transactions.

Paul has been consistently recognized as a leading funds lawyer by *The Best Lawyers in America*, which also named him New York City Private Funds/Hedge Funds Law Lawyer of the Year. He continues to be recognized by *Chambers Global*, *Chambers USA* and *The Legal 500 United States*, as well as many other ranking publications. Paul was honored at The Hedge Fund Journal Awards for his outstanding achievement in the hedge fund industry, and he received a Lifetime Achievement Award from Hedge Funds Care in recognition of his prominence in the hedge funds industry and his extraordinary commitment to philanthropy. He was also named to *HFMWeek*'s 2010 list of the 50 most influential people in hedge funds. Paul serves as a special adviser to the board of directors of the Managed Funds Association (MFA) and he is a former member of the Legal Advisory Board to the National Association of Securities Dealers (NASD). He chairs the Subcommittee on Hedge Funds of the American Bar Association's Committee on Federal Securities Regulation and is a former chair of the New York City Bar Association's Committee on Securities Regulation. Paul is a member of the boards of directors of the NAACP Legal Defense and Educational Fund and the Advisory Board of the RAND Center for Corporate Ethics and Governance, and he is a fellow of the New York Bar Foundation and the Phi Beta Kappa Society. He served on the Advisory Board of Harvard Law School's Center on Lawyers and the Professional Services Industry and formerly served as president, vice president and a trustee of the Harvard Law School Alumni Association of New York City. He is also a member of The Economic Club of New York. Additionally, Paul has served as a lecturer at the University of Pennsylvania's Wharton School, where he taught "Responsibility in Professional Services." He is also an adjunct professor of finance at NYU Stern School of Business, where he has taught "Managing Financial Businesses," and an adjunct professor of law at New York University School of Law, where he teaches "Advising and Managing Financial Services Businesses." He is a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press).

Paul received his J.D., *cum laude*, from Harvard Law School, after which he was awarded a Fulbright Fellowship to study law in the Netherlands. He received his A.B., *magna cum laude*, from Harvard College, where he was Phi Beta Kappa.

Partner and
Chief Executive Officer

Perella Weinberg Partners

Robert K. Steel

Bob is a partner and serves as chief executive officer at Perella Weinberg Partners. Prior to joining the firm, as New York City's Deputy Mayor for Economic Development from 2010 to 2013 he was responsible for Mayor Michael Bloomberg's administration's five-borough economic development strategy and job-creation efforts, overseeing such agencies as the Department of Housing Preservation and Development, Department of City Planning, Department of Small Business Services, NYC Economic Development Corporation and NYC & Company, and chairing the Brooklyn Bridge Park board. A key initiative of the Bloomberg administration was to encourage and grow the technology sector of New York City's economy, and Bob led the applied sciences initiative, which established the Cornell-Technion campus on Roosevelt Island and the New York University Center for Urban Science and Progress initiative in Brooklyn, New York.

Prior to his appointment as Deputy Mayor, Bob was the president and CEO of Wachovia where he oversaw the sale of the bank to Wells Fargo & Co. and served on the Wells Fargo board of directors until 2010. During his tenure at the U.S. Treasury as Under Secretary for Domestic Finance from 2006 to 2008, he revived the President's Working Group, the core group to respond to the global economic crisis of 2008. He managed the Department's Blueprint for Modernized Regulatory Structure, which recommended several of the reforms since pursued by the Obama administration. Bob also spent nearly 30 years at Goldman Sachs, rising to head of the global equities division, vice chairman of the firm and a member of its Management Committee. He began his Goldman Sachs career in Chicago and then spent more than seven years in London before returning to the United States to work in the New York headquarters. He also was a member of the board of directors of Barclays from 2005 to 2006.

Bob is a graduate of Duke University and the University of Chicago's Booth School of Business. He is chairman of the Aspen Institute's Board of Trustees and has served as chairman of Duke's Board of Trustees, Senior Fellow at Harvard University's Kennedy School of Government, a member of the FDIC Advisory Committee on Economic Inclusion, chairman of The After-School Corporation, and co-founder of SeaChange Capital Partners, an organization dedicated to helping nonprofits grow.

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Shlomo is co-head of the Tax Group at Schulte Roth & Zabel. He focuses his practice on the tax aspects of onshore and offshore investment funds, registered investment companies and business development companies, private equity partnerships, real estate and corporate transactions, restructurings and workouts, securitizations, and existing and emerging financial instruments. He also provides ongoing tax advisory services to a number of hedge fund managers regarding fund structuring and formation, distressed debt investments and other complex transactions.

Recognized as a leader in his field by *Chambers USA*, *The Best Lawyers in America*, *The Legal 500 United States* and the *Tax Directors Handbook*, Shlomo is a member of the Tax Section of the New York State Bar Association. He regularly speaks at industry conferences and events, and his most recent presentations have addressed hedge fund and management company structures, funds in the energy space, tax considerations for private investment funds and FATCA. He is a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) as well as various SRZ alerts.

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Holly focuses her practice on the representation of employers in all aspects of employment law and employee relations. She also serves as co-head of Schulte Roth & Zabel's Cybersecurity Group. Holly litigates disputes involving restrictive covenants, ERISA claims, executive compensation, employment agreements, statutory employment discrimination claims, and common law tort and contract claims in federal and state courts, before administrative and government agencies and in arbitral forums. She advises employers on employment law compliance, best practices, human resources matters, hiring and termination, and litigation avoidance; drafts and negotiates employment agreements, separation agreements, data security and privacy policies and other employment-related agreements; and provides training and conducts investigations.

Recognized as a leading lawyer by *The Best Lawyers in America* and as one of the "Top Women Attorneys in the New York Metro Area" by *New York Super Lawyers*, Holly is a member of the Labor and Employment Law Section of the New York State Bar Association. She speaks and writes often about topics of interest to employers in the investment management industry, having most recently addressed hedge fund compensation, hiring and employee agreement trends, as well as protecting workforces and hiring from competitors. Her recent publications include "Securities, Futures Regulators Increase Scrutiny, Expectations on Cybersecurity" in *Bloomberg Brief – Financial Regulation*, "Recent Labor Department Actions Target Independent Contractor Misclassification, Overtime" in *Westlaw Journal – Employment* and "Now We Know How NYC's Credit Check Ban Will Be Interpreted" in *Law360*.

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Practice

Structured Finance & Derivatives

Boris Ziser

Boris serves as co-head of Schulte Roth & Zabel's Structured Finance & Derivatives Group. With over 20 years of experience across diverse asset classes, he focuses on asset-backed securitizations, warehouse facilities, secured financings and commercial paper conduits. His practice encompasses a variety of asset classes, including life settlements, equipment leases, structured settlements, lottery receivables, timeshare loans, litigation advances and cell towers, in addition to other esoteric asset classes such as intellectual property and other cash flow-producing assets. Boris also represents investors, lenders, hedge funds, private equity funds and finance companies in purchases and dispositions of portfolios of assets and financings secured by those portfolios.

Boris serves as outside general counsel to the Institutional Longevity Markets Association (ILMA), and he is a member of the New York State Bar Association and the New York City Bar Association, as well as the Esoteric Assets Committee of the Structured Finance Industry Group. He is listed in *Chambers USA* and recognized by *The Legal 500 United States* for his work in structured finance. A frequent speaker at securitization industry conferences, Boris has conducted various securitization and life settlement seminars in the United States and abroad, having most recently addressed the current legal landscape for life settlements. He is also the co-author of "Structured Insurance Finance" and "Life Settlement Securitization" in *Securitizations: Legal and Regulatory Issues* (ALM Law Journal Press) and the author of "The Life Settlement Industry Today" in *The Journal of Structured Finance*.

Boris earned his J.D. from New York University School of Law and his B.A., with honors, from Oberlin College.

Evolving Terms and Considerations Across the Fund Spectrum

I. Trends in Capital Raising

A. The Evolving Dynamics of the Hedge Fund Industry

1. Growth continues to be a high priority for managers.

(a) Many of the largest managers are focused on cross-selling products and becoming a "one-stop" shop for investor needs.

(b) Managers are focused on offering new strategies or variations of existing strategies.

2. To attract additional capital, managers are adding strategies and seeking new investors.

A recent survey of managers indicates that:

(a) 61 percent of larger managers (over $10 billion of assets under management) are adding new hedge fund strategies.

(b) 72 percent of mid-sized managers ($2 billion to $10 billion of assets under management) are expanding their investor base.

(c) 86 percent of small managers (under $2 billion of assets under management) are expanding their investor base.[1]

B. Investor Concentration

1. In some instances, new funds are being offered to a concentrated group of institutional investors for various reasons including:

(a) To obtain investments from larger institutional investors that are more likely to agree to longer lock-up periods and/or investor level gates;

(b) Because the fund or investment strategy has limited capacity; or

(c) To expedite the timing of launching the new product (e.g., co-investments).

2. Larger institutional investors are more likely to request material changes to fund terms and side letters (as discussed further below).

II. Trends in Structures, Terms and Products

A. Fees

1. Management Fee

(a) Management fee rates face continued downward pressure.

[1] *See* Ernst & Young, 9th Annual EY Global Hedge Fund and Investor Survey.

(b) The standard management fee rate is no longer 2 percent. Management fee rates tend to range from 1.25 percent to 1.75 percent.

(c) In addition to a lower management fee base rate, investors have required some managers to scale down the management fee rate if the fund reaches a certain size. For example, if the fund reaches $1 billion in assets under management, the management fee rate may be reduced by up to 50 basis points.

(d) Specialized Funds, Strategies and Classes

(i) Commodities funds often charge the management fee on notional amounts.

(ii) Some lending funds charge the management fee on gross asset value.

(iii) Some levered funds also charge the management fee on gross asset value or increase the management fee rate.

(iv) Managers that utilize commitment classes (as discussed below) generally charge the management fee on "invested capital" or net asset value, and not on the capital commitment amount (as is the case in a private equity fund).

(v) Highly specialized trading funds (e.g., quantitative funds) with higher operational expenses may charge a higher management fee rate (e.g., a 3-percent management fee).

(vi) Single investor funds typically have customized management fee rate provisions.

2. Incentive Compensation

(a) Incentive compensation base rates have remained at 20 percent. However, managers typically offer discounts to early-stage and/or large investors.

(b) Specialized Funds, Strategies and Classes

(i) Managers with specialized investment strategies can command an incentive compensation rate higher than 20 percent (e.g., quantitative funds and commodities funds).

(ii) Long-only products typically charge the incentive compensation based on outperforming a hurdle rate or index.

(iii) Single-investor funds typically have customized incentive allocation provisions, including preferred return or hurdle mechanics.

3. Fee Breaks

(a) Managers have been more willing to agree to fee discounts for early-stage and/or large investors.

(b) In determining whether an investor is a "large" investor, managers often look at the overall relationship with the manager and its funds. Managers look at not only the size of an investor's investment in the applicable fund, but also the amount of an investor's investment on an aggregate basis across all of the funds and accounts managed by the same manager. Investors who are managed or advised by the same adviser on a discretionary basis may be aggregated in determining the aggregate investment by those investors for purposes of determining the discount on fees.

(c) Fee deals may be disclosed in the fund's confidential memorandum to provide transparency to investors and may be offered to all investors who meet a certain investment threshold.

4. Conduit Funds

(a) Some managers are accommodating larger investors who request a single fund (a "conduit fund") to facilitate investment in multiple funds managed by a single manager.

(b) A conduit fund allows an investor to get the benefit of paying fees on an aggregated basis.

(c) A conduit fund may be viewed as an affiliate of the manager and, as such, a manager may need to take into account ERISA considerations when structuring such a fund. A manager should also be cognizant of potential most-favored-nations implications, as the conduit fund may not pay fees at the underlying fund level.

B. Founders' Classes

1. Managers continue to offer "founders' classes" to entice early investors.

(a) Founders' classes typically provide discounts to the management fee and/or incentive compensation.

(b) In exchange, investors in founders' classes may agree to lock-up periods during which they either are unable to redeem capital or can redeem subject to a redemption charge.

(c) The fee discounts may depend on the size of investment and/or the length of lock-up period.

2. Expiration of Founders' Classes

(a) Founders' classes typically have an expiration that is tied to the fund reaching a certain level of assets under management or a time period (or both). For example, the expiration could be tied to the fund reaching $250 million in assets under management or the first six months after the initial close of the fund, whichever comes first.

(b) Managers typically retain the flexibility to extend the time period during which investors can purchase the founders' class.

3. Founders' class investors are sometimes granted a right to invest additional capital on the same terms as the founders' class even after the founders' class is otherwise closed, but typically only for a limited period of time.

4. The terms of founders' classes are typically found in the fund's confidential memorandum (as opposed to a supplement or side letter) to provide transparency to all investors.

C. Liquidity

1. Redemption Terms

(a) Redemption terms are more closely aligned to a fund's investment portfolio and/or strategy.

(b) A fund typically has less frequent redemption rights when its underlying assets are less liquid and/or where it is required by its strategy and investment horizon.

2. Gates

(a) Investor-level gates continue to be popular.

(b) Investor-level gates are used to stabilize cash flow out of the fund and provide a more predictable redemption schedule.

(c) 25-percent investor-level gates remain the most common investor-level gate.

(d) Certain investment strategies (e.g., credit, activism) may include gates that increase the length of time that it would take an investor to redeem completely under the investor-level gate from four quarters to eight quarters or even 12 quarters.

3. Lock-Up Periods

(a) Lock-up periods are becoming more common again.

(b) An initial one-year lock-up period (in addition to investor-level gates) is typical, although managers may ask for longer lock-up periods in exchange for discounts on fees in their founders' classes (as discussed above).

4. Redemptions During a Lock-Up Period

(a) "Soft" lock-up periods are being utilized more often, whereby an investor is permitted to redeem during the lock-up period, subject to a redemption charge. The redemption charge that is deducted from an investor's redemption proceeds typically ranges from 2 percent to 5 percent.

(b) Some funds that have a lock-up period that is longer than one year permit investors to redeem a certain percentage of their investment in the fund on an annual basis during the lock-up period.

5. Terms Applicable to Internal Capital Invested in the Fund

(a) Investors are focusing on internal capital (i.e., general partner/manager/principal) and the redemption terms applicable thereto. While internal capital invested in a fund used to have better liquidity than such fund's investors, the liquidity of internal capital is typically the same as the liquidity of third-party investors. Also if the general partner does not withdraw the incentive allocation within a certain time frame after it is allocated, then such amounts also often become subject to the same liquidity terms as the fund's third-party investors.

(b) A principal often commits to invest and keep a certain level of investment in the fund (e.g., a minimum investment amount or a portion of the principal's liquid net worth).

(c) Some institutional and other investors require notification when (or before) the general partner/principal redeems a certain amount or percentage of its investment from the fund. These notification rights typically include carve-outs for tax distributions and the prior year's incentive compensation. Carve-outs sometimes also include capital redeemed to invest in new products.

(d) Some managers have offered a proportional redemption right whereby an investor can redeem a proportionate amount from the fund when the general partner/principal makes a redemption.

6. Reserves and Holdbacks

(a) Historically, audit reserves ranged from 5 percent to 10 percent.

(b) Investors are more frequently requesting that the holdback percentage be consistent with the assets of the fund (e.g., a long/short equity fund is likely to have a lower audit holdback percentage, such as 2 percent).

(c) Limits on Non-GAAP Reserves: Investors are seeking limits on the ability to take non-GAAP reserves, with certain investors requesting or even requiring that managers only take GAAP reserves.

7. Strategy-Specific Liquidity

(a) Strategies that invest in less liquid assets (e.g., credit and distressed credit) have included more complicated liquidity terms such as "fast pay/slow pay." Under these redemption terms, on each redemption date, assets are labeled as "fast-pay assets" and "slow-pay assets." The investor is paid out the percentage of its redemption request that is attributable to the fast-pay assets within 30 to 45 days of the redemption date. The investor is paid from the proceeds from the slow-pay assets as they are liquidated in the ordinary course of the business of the fund. Slow-pay mechanics allow for the manager to liquidate the slow-pay assets as if the redemption request had not been made.

(b) Investors expect long-only equity funds to offer quarterly, monthly or even more frequent liquidity.

(c) Insurance-dedicated funds are funds designed exclusively for insurance policy investors. Such investors require the ability to redeem capital from time to time to pay for: (i) death benefits; and (ii) insurance policy premiums. Also, investors in insurance-dedicated funds can only receive cash as distribution proceeds.

D. Private Investments

1. Managers are showing a renewed interest in less liquid and private investments, and are seeking ways to make these investments.

2. Investments may be made: (i) in the general investment portfolio of the fund; (ii) by re-introducing side pocket provisions into the fund; or (iii) through a separate vehicle (e.g., co-investments, sidecars and traditional private equity funds).

3. Fiduciary issues may arise if a fund does not have side pocket mechanics and instead makes these investments through the general investment portfolio of the fund.

4. A side pocket is a mechanism used by a fund to segregate less liquid (or difficult to value) investments from the liquid portion of the fund's investment portfolio. The side-pocketed investment is segregated from the rest of the fund's investment portfolio, and incoming investors do not participate in existing side pocket investments. Investors generally are not permitted to redeem amounts that are side-pocketed until after the side-pocketed investment is realized, and typically,

performance compensation on any gains on the side-pocketed investment is not taken until the time of realization.

5. Investors may still be wary of side pockets.

   As a result, some managers have offered an opt-in/opt-out feature in connection with side pockets.

   (a) The opt-in/opt out feature allows an investor to elect to opt out of all (but generally not less than all) of the fund's side-pocket investments at the time of its admission to the fund.

   (b) Some managers have also permitted an investor to elect to choose its level of participation in side pockets at the time of its admission to the fund (i.e., 10 percent or 20 percent of its investment in the fund).

   (c) An opt-out feature does not effectively deal with an existing investment held by the fund that is subsequently deemed to be illiquid.

E. Side Letters

1. Investors are requesting broader side-letter provisions, including:

   (a) Greater transparency on the business of the manager including disclosure in connection with:

      (i) A more comprehensive list of "regulatory events";

      (ii) General partner/manager/principal redemptions;

      (iii) Changes in service providers;

      (iv) Changes in the allocation policy of the manager with respect to the fund;

      (v) Changes in the valuation policy of the fund; and

      (vi) Changes in the investment program of the fund.

   (b) Mandate that any in-kind distributions be made on a pro rata basis among the fund's investors

   (c) Most-favored-nation clause on material terms in respect of the fund and any parallel vehicles (e.g., in respect of fees, liquidity and transparency) and the ability for the investor to convert its investment into any newly offered class

   (d) Limits on non-GAAP reserves

   (e) Decrease in the audit holdback

   (f) Scale down on the management fee rate when redemptions from the fund are suspended

   (g) Right to inspect the books and records of the fund

2. Some managers have built side-letter terms into the fund's confidential memorandum to provide all investors with the same terms.

F. Expenses

1. Fund Expenses

   (a) Increased investor and regulatory scrutiny on expenses has led to reviews of the litany of "permitted expenses" that are disclosed and permitted to be charged to a fund. Investors have been closely scrutinizing fund expenses, especially regulatory, D&O insurance, investment-related travel, costs of shadow accounting and research expenses, and the use of soft dollars.

   (b) Managers are providing more detailed descriptions of the expenses borne by the fund in the confidential memorandum.

   (c) Clarifications in the confidential memorandum have been made in many cases so that software consultant fees, order management systems and certain forms and filings are included in the expense sections.

2. Fund expense caps are occasionally seen but remain rare. There tends to be two types of expense caps: (i) caps on organizational expenses; and (ii) caps on operating expenses.

3. Strategy-Specific Expenses: Some quantitative managers charge hardware and software expenses to the funds, which are typically a manager expense.

G. Capital Commitments

1. Some hedge fund managers are using a capital commitment structure. The circumstances where they are being used include:

   (a) Funds that are otherwise closed to new investors;

   (b) Funds that are still open to new investors where certain investors have specifically requested this class; and

   (c) New funds in order to secure capital for investments.

2. Capital commitments are typically seen in funds where the manager needs time to ramp up the investment portfolio or otherwise expects to make investments infrequently and does not want to tie up an investor's capital or dilute the internal rate of return if it does not have available investment opportunities.

3. Instead of the typical monthly subscriptions, an investor would commit a certain amount of capital to the fund that is drawn down by the manager as and when needed.

4. When establishing commitment classes, managers need to consider:

   (a) The time lag between calling capital and funding relative to the timing of making the investment; and

   (b) Default remedies in the event an investor does not fund its commitment.

5. Fund-Specific Considerations: Commitment classes have been offered across concentrated funds, credit funds and opportunistic funds.

Private Funds: The New Banks

I. Issues for Funds as Providers and Users of Leveraged Loans

A. Leveraged Loan Market in 2015

1. Compared to 2014, 2015 Was a Year of Slowly Tightening Liquidity, High Leverage and Default Rate Uptick

(a) U.S. leveraged loan volume in 2015 exceeded $424 billion as of Dec. 14, 2015, which is down almost 20 percent from the $526 billion at this point last year, according to data provider S&P Capital IQ.

(b) High-yield bond issuance totaled $263 billion as of Dec. 14, 2015, a 15-percent drop from the $310 billion at this point in 2014, according to S&P Capital IQ.

(c) According to Capital IQ, the average total debt to EBITDA leverage multiple for highly leveraged deals is 5.1x through Nov. 15, 2015, and slightly higher for middle market ($50 million of EBITDA or less) LBOs at 5.8x.

(d) Macroeconomic uncertainty about China's growth, U.S. monetary policy, and prices of oil and other commodities created significant headwinds to U.S. economic prospects during the second half of 2015 and served as a drag on leveraged loan activity.

(e) Notable sponsor-led LBO deals in 2015 include:

(i) The $8.6-billion acquisition of Petsmart, a retailer of pet supplies, by BC Partners closed in March 2015 and involved $5.0 billion of financing ($4.3-billion term loan and $750-million revolver).

(ii) The $6.5-billion acquisition of software provider Solera Holdings led by Vista Equity Partners was announced in September 2015 in a deal expected to close in Q1 2016 with expected financing of $4.23 billion ($0.3-billion revolver/$3.93-billion mix of term debt and unsecured debt).

(iii) The $4.9-billion acquisition of Informatica, a provider of enterprise data integration software and services, by Permira, closed in August 2015 with $2.5 billion of financing ($1.71-billion term loan, $150-million revolver and $650 million in bonds).

(iv) The $4-billion acquisition of gym operator Life Time Fitness by Leonard Green & Partners and TPG Capital closed in June 2015 with $1.95 billion of financing ($250 million revolver, $1.25 billion term loan and $450 million 144A bond).

(v) The $3-billion acquisition of department-store chain Belk Inc. by Sycamore Partners closed in December 2015 with $2.95 billion of financing ($900-million revolver, $1.5-billion first-lien term loan and $550-million second-lien term loan).

(f) Despite the high levels of leverage and the large amounts of distressed debt, the default rate of issuers in the S&P/LSTA Leveraged Loan Index stood at 1.54 percent as of November 2015. While this level represents a nine-month high and is impacted by recent defaults in energy-related sectors, it remains well inside the historical average of 3.15 percent for loans tracked in the S&P/LSTA Leveraged Loan Index.

2. Reasons for Low Levels of Default During Period of High Leverage

(a) One key reason is the unprecedented levels of liquidity from non-traditional lenders, such as hedge funds and CLOs.

(b) The large amount of liquidity provided by hedge funds and CLOs, together with low interest rates and a slowly expanding (albeit tepid) economy, have led to lower incidents of defaults (excluding defaults caused by the recent unusually sharp retraction in the energy sector).

(c) The competition among lenders for deals during periods of robust merger and acquisition activity and ample liquidity sources has also resulted in thinner pricing and weaker covenant packages, such as the so-called “covenant lite” deals, and generous sponsor equity cure provisions affording borrowers with additional cushion on financial covenants to reduce the risk of defaults.

(d) Views vary: Either (i) the highly leveraged companies today have better risk profiles than the highly leveraged companies during the 2003-2007 period; or (ii) today’s deals are creating the higher default rates of tomorrow.

B. Second-Lien Loans: What Are They, How They Started and What They Have Become

1. What Is a Second-Lien Loan?

(a) A second-lien loan is typically a term loan secured by a lien on certain assets (typically, substantially all assets) of the borrower where: (i) the borrower has also granted another lender (the first-lien lender, which is typically a working capital lender) a lien on the same assets; and (ii) the first-lien lender has the right to receive and apply the proceeds from the sale, disposition of, or other realization from, those assets to the payment of the first-lien lender’s loan prior to the payment of the second-lien loan. A second-lien loan is typically not contractually subordinated debt.

(b) In its simplest form, debt subordination provides that the senior debt (as contractually defined) is paid before payment on subordinated debt. In addition, debt subordination typically includes the following: payment blocks; remedy blocks (including acceleration and commencement of bankruptcy or other proceedings); in bankruptcy, no payment on subordinated debt before senior debt is paid in full and no right to receive securities unless subordinated at least to the same extent as the subordinated debt is subordinated to the senior debt; and turnover provision covering any money/value received from any source. Examples: typical high-yield bonds and certain mezzanine debt may be contractually subordinated debt.

2. How Is a Second-Lien Loan Different from Subordinated Debt?

(a) Lien subordination involves no payment block; remedy blocks limited to remedies with respect to collateral; bankruptcy results in all collateral proceeds going to holder of senior lien; turnover provision only covers proceeds received from shared collateral and certain remedies related to collateral.

(b) A true lien subordination agreement typically provides that if the lien of the first-lien lender becomes unperfected, and the second-lien lender receives proceeds of shared collateral, the second-lien lender retains such proceeds. If the liens of both lenders are unperfected as to certain collateral, then their liens are pari passu with respect to that collateral. A senior lien must be valid, perfected and enforceable for lien subordination to apply.

(c) Debt subordination results in a subordinated debt holder being behind the senior debt and pari passu with the unsecured trade creditors. Lien subordination results in the subordinated lien holder being: (i) behind the senior lien holder to the extent of the shared collateral, and (ii) ahead of the unsecured trade creditors to the extent of its collateral.

(d) Resolution of intercreditor issues in the second-lien market are not as well defined as the intercreditor issues in the subordinated debt market.

3. Basic Dynamics Between First-Lien Lenders and Second-Lien Lenders

(a) First-lien lenders do not want to suffer diminution of their expected rights and remedies as secured creditors by virtue of a second-lien lender having a second priority lien on the same collateral — i.e., "they don't want to lose anything meaningful." First-lien lenders do not want any "Monday morning quarterbacking" or other increased litigation risk. The second-lien lender should not be able to use its status as a secured creditor to impede the first-lien lender's exercise of rights and remedies.

(b) Second-lien lenders want to enjoy the benefits of secured creditor status, acknowledging that the first proceeds of the collateral must be used to repay the first-lien lenders. The degree to which the second-lien lender's secured creditor rights are controlled or ratcheted back should be compensated for by the differential in coupon between the two classes of investments.

4. What Is the Difference Between Broadly Syndicated and Middle Market Second-Lien Debt?

(a) "Middle Market Second-Lien Deals" — Often hedge fund-originated deals

(i) "Aggressive second lien."

(ii) First lien must be valid, perfected and enforceable for turnover provision to apply.

(iii) Few upfront consents/waivers in a bankruptcy.

(iv) Intercreditor points are more often hand-crafted to address deal specifics and commercial dynamics.

(b) "Broadly Syndicated Second-Lien Deals" — Wall Street Institutional Second Lien Deals — Larger Syndicated Second Lien Deals; High-Yield Bond Deals

(i) "Silent second lien" or "limited silent second lien"; typically much deeper lien subordination.

(ii) First lien need not necessarily be valid, perfected and enforceable for turnover provision to apply.

(iii) More upfront consents/waivers in a bankruptcy (i.e., consent to DIP, adequate protection, asset sales, plan classification, voting).

(iv) High-yield bond deals have similar structuring issues as the Wall Street Institutional Second Lien Deals.

5. How Second-Lien Loans Started and What They Have Become

(a) Second-lien loans started as a niche asset-based or rescue financing product in the late 1990s and early 2000s for borrowers facing liquidity problems.

(b) The market for second-lien loans started getting attention in 2003, and it exploded in 2004 and 2005.

(c) As the economy improved starting in 2003, second-lien loans were used not only for rescue financing but for buyout financing, dividend recapitalizations and refinancings.

(d) According to *The Deal*, in 2003, second-lien loans totaled about $3 billion. In 2005, second-lien loans rose to more than $17 billion. Fitch Ratings noted that second-lien issuance in 2014 totaled $38.7 billion, just shy of the 2007 record of $39.2 billion. However, through Nov. 15, 2015, second-lien issuance amounted to only $13.1 billion according to Thomson Reuters.

(e) Hedge funds, along with CLOs, have become significant investors in second-lien loans.

(f) Some recent second-lien deals include:

(i) $345-million loan to finance Apax Partners' acquisition of FullBeauty in October 2015

(ii) $305-million loan to finance Centerbridge Partners' acquisition of IPC Systems in March 2015

(iii) $260-million loan to finance Lone Star Funds' acquisition of Hanson Building in March 2015

(iv) $260-million loan to finance Apollo Management's acquisition of Protection One in July 2015

(v) $245-million loan to finance Warburg Pincus' acquisition of Universal Services of American in August 2015

(g) Most market participants believe that second-lien loans have become a permanent asset class.In bull markets they will be used to finance buyouts and dividends recapitalizations, and in bear markets they will be used as rescue financings.

(h) Today, many borrowers view second-lien loans as preferable to mezzanine loans and high-yield bonds for the following reasons:

(i) Faster execution than high-yield bonds

(ii) Cheaper transaction costs than high-yield bonds and lower interest rates than mezzanine loans

(iii) For nonpublic companies, no public reporting or Sarbanes-Oxley compliance

(iv) No onerous prepayment penalties

(v) No amortization

6. Significant Issues When Considering a Second-Lien Investment

   (a) Structural and Valuation Analysis: Despite what some may say, there are not standard terms and structures in the second-lien market.

   (b) Covenant Setbacks: Do they provide sufficient protection?

   (c) Intercreditor Agreement Terms

      (i) Pre-Bankruptcy

         (1) Extent and duration of standstill

         (2) Should the cap on first-lien debt be permanently reduced by payments?

         (3) Sales or Releases of Collateral: Waiver of prepayment by first-lien lender. Can the second-lien lender object to asset sales?

         (4) May a lender amend or waive its economic terms, financial covenants or other material terms without the consent of the other lender?

         (5) Does a buy-out right provide meaningful protection?

      (ii) Post-Bankruptcy

         (1) Consents to DIP financing and cash collateral: What are the conditions?

         (2) Rights to adequate protection and post-petition interest

         (3) Waivers with respect to Section 363 sales, classification of claims in a plan of reorganization and voting for a plan of reorganization

   (d) Post-Closing Monitoring: Do hedge funds have the resources to monitor and, if needed, restructure loans?

II. Volcker Rule Update: Agencies Clarify Ability of Non-U.S. Banks to Invest in Third-Party Funds

A. On Feb. 27, 2015, the Commodity Futures Trading Commission ("CFTC"), Federal Deposit Insurance Corporation ("FDIC"), Board of Governors of the Federal Reserve System (the "Board"), Office of the Comptroller of the Currency and Securities and Exchange Commission ("SEC") (collectively, the "Agencies") published a new FAQ on the Agencies' rule promulgated under Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which is commonly referred to as the "Volcker Rule."[2] The new FAQ now makes clear that the Volcker Rule does not necessarily prohibit non-U.S. banking entities from investing in third-party managed hedge funds and private equity funds, even where the ownership interests of such funds are marketed and sold to U.S. investors.[3]

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[2] An SRZ *Alert*, "Summary of Final Volcker Rule Regulation — Fund Activities," available at www.srz.com/Summary_of_Final_Volcker_Rule_Regulation_Fund_Activities/, summarizes the Volcker Rule's effect on fund activities.

[3] The new FAQ (#13) is available on the Federal Reserve's website at www.federalreserve.gov/bankinforeg/volcker-rule/faq.htm.

B. The Volcker Rule contains an exemption that permits eligible non-U.S. banking entities[4] to hold ownership interests in "covered funds," so long as such activity occurs "solely outside the United States." This exemption, commonly known as the "SOTUS exemption" requires, among other conditions, that "no ownership interest in the covered fund is offered for sale or sold to a resident of the United States."[5] However, the FAQ makes clear that this requirement does not prevent a third-party manager from offering or selling the fund's interests to U.S. investors, so long as *the banking entity* is not involved in such marketing or sales activity. In other words, eligible non-U.S. banking entities will still be able to invest in third-party funds regardless of whether those funds also have U.S. investors, so long as they do not participate in marketing the fund.[6]

C. To avail themselves of the SOTUS exemption, eligible non-U.S. banking entities will still have to ensure that:

1. The banking entity (or office thereof) holding the investment, as principal (and the banking entity (or office thereof) that has decision-making authority over the investment, if different), is not organized or located in the United States;

2. No relevant personnel of the banking entity with decision-making authority over the investment are located in the United States (excluding "back office" personnel);

3. The investment is not accounted for as principal, directly or indirectly, on a consolidated basis by a branch or affiliate organized or located in the United States; and

4. No financing for the investment is provided, directly or indirectly, by a branch or affiliate organized or located in the United States.

III. Summary of Final Volcker Rule Regulation: Proprietary Trading

On Dec. 10, 2013, the Agencies issued a final rule (the "Final Rule") implementing the Volcker Rule.[7] The Volcker Rule restricts the proprietary trading and private investment fund activities of U.S. banks and their affiliates, as well as foreign banks with a branch or agency office in the United States and their affiliates (collectively, "banking entities").[8]

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[4] In order for a banking entity to use this exemption, the following criteria must be satisfied:

(i) The banking entity must not be organized, or directly or indirectly controlled by a banking entity organized, in a U.S. jurisdiction (including any U.S. territory or commonwealth);

(ii) If the entity is a "foreign banking organization" under 12 C.F.R. Part 211 ("Regulation K"), it must qualify for the exemption thereunder;

(iii) If the entity is not a "foreign banking organization" under Regulation K, it must satisfy at least two of the following:

a. Its total assets held outside the United States exceed those held in the United States;

b. Its total revenues from its non-U.S. business exceed those from its U.S. business;

c. Its total net income from its non-U.S. business exceed that from its U.S. business.

[5] E.g., 12 C.F.R. § 248.13(b)(iii).

[6] Furthermore, if the banking entity (or an affiliate) acts as sponsor or serves, directly or indirectly, as the investment manager, investment adviser, commodity pool operator or commodity trading advisor to a covered fund, the banking entity automatically will be deemed to be participating in the marketing of the fund's ownership interests.

[7] The Agencies, with the exception of the CFTC, issued a joint final rule release. The CFTC issued a separate but virtually identical release.

[8] For the purposes of the Final Rule, the term "affiliate" means any company that controls, is controlled by, or is under common control with another company. A company controls another company if: (i) the company directly or indirectly or acting through one or more other persons owns, controls or has power to vote 25 percent or more of any class of voting securities of the company; (ii) the company controls in any manner the election of a majority of the directors of trustees of the other company; or (iii) the board determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the company. For purposes of the Final Rule, the term "affiliate" would not include any affiliated entity that is: (i) a "covered fund" (as defined by the Final Rule); (ii) a portfolio company held by a bank, pursuant to its merchant banking authority; or (iii) a "portfolio concern" (as defined by 13 C.F.R. § 107.50) controlled by a "small business investment company" (as defined in the Small Business Investment Act of 1958).

The text of the Final Rule was more than 70 pages long, while the supplemental guidance issued with it numbered nearly 900 pages and contained more than 2,800 footnotes. While the Final Rule is largely similar to the Notice of Proposed Rulemaking issued by the Agencies in 2011 (the "Proposed Rule"),[9] it does contain numerous important modifications from the Proposed Rule. Banking entities had until July 21, 2015 to comply with the Final Rule's restrictions. However, banking entities with $50 billion or more in trading assets and liabilities[10] were required to comply with certain reporting obligations by June 30, 2014.

The Final Rule affects a banking entity's ability to engage in "proprietary trading,"[11] generally prohibiting a banking entity from engaging in such activity, subject to certain exemptions discussed below.

A. What Constitutes 'Proprietary Trading'?

"Proprietary trading" is defined as a banking entity engaging, as principal, in any purchase or sale of a "*financial instrument*" for a "*trading account*." Thus, the scope of the prohibition on proprietary trading is determined by the definitions of "financial instrument" and "trading account."

1. What Is a "Financial Instrument"?

As noted above, for a purchase or sale[12] to constitute proprietary trading under the Final Rule, it must involve a "*financial instrument*." The Final Rule defines a "financial instrument" as any:

(a) Security (as defined in Section 3(a)(10) of the Securities Exchange Act of 1934 (the "'34 Act"));

(b) Derivative (including any: (i) swap; (ii) security-based swap; (iii) physically deliverable commodity forward (except where involving an "excluded commodity" under Section 1a(19) of the Commodity Exchange Act ("CEA")); (iv) deliverable foreign exchange forwards; (v) foreign exchange swaps; (vi) retail foreign exchange transaction; or (vii) retail commodity transaction);[13]

(c) Commodity future;[14] or

(d) Option on any of the foregoing.

The Final Rule explicitly excludes from the definition of financial instrument, any:

(e) Loan, lease, extension of credit, or secured or unsecured receivable that is not a security or derivative;

(f) Foreign exchange or currency; or

[9] The Agencies, with the exception of the CFTC issued the Proposed Rule on Oct. 11, 2011. The CFTC issued its version on Feb. 14, 2012.

[10] Which for a U.S. banking entity is measured by the average gross sum of trading assets and liabilities (excluding those involving obligations of the United States or any U.S. agency), on a worldwide consolidated basis at the end of each of the previous consecutive four quarters. A non-U.S. banking entity need only include its combined U.S. operations (including all affiliates or offices operating, located or organized in the United States) in its calculation.

[11] See the SRZ *Alert*, "Summary of Final Volcker Rule Regulation — Fund Activities," available at www.srz.com/Summary_of_Final_Volcker_Rule_Regulation_Fund_Activities/, for a summary of the Final Rule's effect on fund activities.

[12] With respect to a derivative, such terms include the execution, termination (prior to its scheduled maturity date), assignment, exchange, or similar transfer or conveyance of, or extinguishing of rights or obligations under, a derivative, as the context may require.

[13] However, excluded for this purpose are: (i) instruments that the SEC and CFTC have jointly determined are not swaps or security-based swaps; or (ii) any identified banking product, as defined in Section 402(b) of the Legal Certainty for Bank Products Act of 2000.

[14] For this purpose, a commodity future is a "contract of sale" (as defined in Section 1a(13) of the CEA) for "future delivery" (as defined in Section 1a(27) of the CEA).

(g) Commodity[15] (except for (i) any "excluded commodity" (as defined above), other than foreign exchange or currency; or (ii) any commodity that is, itself, a derivative or a commodity future or option thereon).[16]

2. What Is a "Trading Account"?

As noted above, the purchase or sale of a financial instrument by a banking entity will not constitute proprietary trading *unless* it is done for a "*trading account*."[17] Under the Final Rule, the following three categories of transactions would be deemed to occur for a trading account:

(a) Purpose Test: Any purchase or sale of a financial instrument principally for the purpose of: (i) short-term resale; (ii) benefitting from actual or expected short-term price movements; (iii) realizing short-term arbitrage profits; or (iv) hedging one or more of the foregoing positions, would be deemed to occur in a trading account.

Rebuttable Presumption: A purchase or sale of a financial instrument will be presumed to occur in a trading account if the banking entity holds the instrument for less than 60 days (or "substantially"[18] transfers the risk of the instrument within 60 days of the transaction), unless the banking entity can demonstrate that it did not purchase (or sell) the financial instrument principally for any of the foregoing short-term trading purposes.[19]

(b) Market Risk Rule Test: If a banking entity (or any affiliate thereof) is an FDIC-insured depository institution (or a holding company thereof) that calculates risk-based capital ratios under the market risk capital rule, any purchase or sale of a financial instrument that is both a market risk capital rule covered position and a trading position under the rule (or a hedge of any such position), would also be deemed to occur in a trading account.[20]

(c) Dealer Test: If a banking entity is, or is required to be, licensed or registered with a U.S. regulator as a dealer, swap dealer, or security-based swap dealer[21] (or is acting in a similar capacity outside the United States), then any purchase or sale of a financial instrument in connection with the activities that trigger (or would, if occurring in the United States, trigger) the foregoing licensure or registration obligation would also be deemed to occur in a trading account, *even if the transaction is not made with any short-term trading intent*.[22]

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[15] For this purpose, commodity has the same meaning as in Section 1a(9) of the CEA, except that a commodity does not include any security. However, as noted above, commodity *futures* do constitute financial instruments. Accordingly, the spot purchase of a commodity would meet the terms of the exclusion, but the acquisition of a futures position in the same commodity would not qualify for the exclusion.

[16] While some commenters requested that certain other instruments, such as foreign exchange swaps and forwards, be excluded from the definition of financial instrument, the Agencies indicated that these instruments appear to be, or operate in economic substance as, derivatives (which are, by statute, explicitly included within the scope of instruments subject to the prohibitions of the Volcker Rule).

[17] It is important to note that the term "trading account" is a statutory concept in the Volcker Rule, which the Agencies have clarified is not necessarily meant to refer to an actual account in the normal business or accounting sense. Instead, the Agencies explained, it is simply nomenclature for the categories of transactions that are subject to the Volcker Rule's prohibition.

[18] The Final Rule does not define, nor did the Agencies offer any guidance on, what "substantially" means in this context.

[19] It is important to note that this provision does not create a safe harbor or a reverse presumption. In other words, positions held for more than 60 days are *not* presumed to be outside the scope of proprietary trading.

[20] The Market Risk Rule Test would seem redundant with the Purpose Test, since "covered positions" under the market risk capital rules are positions that are generally held with the intent of sale in the short term. Thus, a market risk rule trading account would appear to also constitute a short-term trading account.

[21] As defined, respectively, in Section 3(a)(5) of the '34 Act, Section 1(a)(49) of the CEA and Section 3(a)(71) of the '34 Act.

[22] The Agencies indicated that they did not view it necessary to limit the scope of a dealer trading account based on short-term intent, because positions held by a registered dealer in connection with its dealing activity are generally held with such intent. Moreover, they argued that the Dealer Test is balanced by the exemptions in the Final Rule for activities typically engaged in by registered dealers, such as underwriting, market making and hedging. Finally, as noted above, this provision does not apply to transactions not related to the activities that require the banking entity to be licensed or registered. (However, such activities may be covered by the Purpose Test or Market Risk Rule Test.)

3. What Activity Does Not Constitute "Proprietary Trading"?

The Final Rule explicitly excludes the following activity from the scope of proprietary trading, even where such activity would otherwise appear to fit the definition:

(a) Non-Principal Activity: Any purchase or sale of a financial instrument by a banking entity that is acting solely as agent, broker or custodian.[23]

(b) Employee Compensation Plans: Any purchase or sale of a financial instrument by a banking entity through a deferred compensation, stock-bonus, profit-sharing, or pension plan of the entity that is established in accordance with U.S. or non-U.S. law, if the transaction is executed directly or indirectly by the entity as trustee for the benefit of its current or former employees (or their immediate family members).[24]

(c) Repos/Reverse Repos and Securities Lending: Any purchase or sale of a financial instrument by a banking entity that arises under:

(i) A written repurchase agreement ("repo") or reverse repurchase agreement ("reverse repo") pursuant to which the entity has simultaneously agreed to both purchase and sell a stated asset, at stated prices, and on stated dates or on demand with the same counterparty; or

(ii) A transaction in which the entity lends or borrows a security temporarily to or from another party pursuant to a written securities lending agreement under which the lender retains the economic interests of an owner of such security, and has the right to terminate the transaction and recall the loaned security on terms agreed by the parties.[25]

(d) Liquidity Management: Any purchase or sale of a *security*[26] by a banking entity for liquidity management purposes, provided it is in accordance with a written liquidity management plan that:

(i) Specifically contemplates and authorizes: (i) the particular securities to be used; (ii) the amount, types and risks of such securities that are consistent with liquidity management; and (iii) circumstances in which such securities may or must be used;

(ii) Requires that any purchase or sale of securities be principally for the purpose of managing the liquidity of the banking entity, and not for any purpose that would satisfy the Purpose Test described above;

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[23] Such activity is excluded because, as noted above, proprietary trading only covers transactions where the banking entity is acting *as principal*. The exclusion also applies where the entity is acting on behalf of an affiliate. However, such activity must still be consistent with the Final Rule from the standpoint of the affiliate that is the principal party to the transaction.

[24] As with the preceding exclusion, this activity is outside the scope of proprietary trading because, here too, the banking entity is not acting as principal. While the Final Rule contains a specific exclusion for an entity's own plans, the Agencies noted that a banking entity's actions on behalf an unaffiliated plan would likely be covered by the preceding exclusion.

[25] This exclusion recognizes that such repo, reverse repos and securities lending transactions are the economic equivalent of secured loans and generally do not constitute proprietary trading (i.e., they are not based on anticipated movements in asset prices). For this reason, only the transactions pursuant to the repo, reverse repo or securities lending agreement are excluded. For example, the collateral or position financed by a repo or reverse repo arrangement is not excluded and, therefore, could involve proprietary trading. Moreover, if a banking entity uses a repo or reverse repo to finance a purchase of a financial instrument, other transactions involving that financial instrument may not qualify for this exclusion. Similarly, short positions resulting from securities lending agreements cannot rely upon this exclusion and may involve proprietary trading.

[26] In keeping with the liquidity management requirements proposed by the federal banking agencies, this exclusion is limited only to securities, rather than all financial instruments.

(iii) Requires that any securities purchased or sold be highly liquid and limited to securities that the entity does not reasonably expect to give rise to appreciable profits or losses as a result of short-term price movements;[27]

(iv) Limits any securities purchased or sold, together with any other instruments purchased or sold for such purposes, to an amount that is consistent with the entity's near-term funding needs, as estimated and documented pursuant to methods specified in the plan;

(v) Includes written policies and procedures, internal controls, analysis and independent testing to ensure that liquidity management activities are conducted in a manner consistent with the Final Rule and the entity's liquidity management plan; and

(vi) Is consistent with the requirements, guidance and expectations of the entity's primary federal regulator.[28]

(e) Existing Delivery or Legal Obligations: Any purchase or sale of a financial instrument by a banking entity that satisfies:

(i) An existing delivery obligation of the entity or its customers (including to prevent or close out a failure to deliver) in connection with delivery, clearing or settlement activity;[29] or

(ii) An obligation of the entity in connection with a judicial, administrative, self-regulatory organization or arbitration proceeding.

(f) Debt Previously Contracted: Any purchase or sale of a financial instrument by a banking entity in the ordinary course of collecting a debt previously contracted in good faith, provided that the entity divests the instrument as soon as practicable within the time period permitted by its primary federal regulator.[30]

(g) DCO/Clearing Agency Transactions: Any purchase or sale of a financial instrument by a banking entity that is a "derivatives clearing organization" ("DCO") or a "clearing agency" in connection with clearing financial instruments;[31]

(h) Clearinghouse Member Activity: Any "excluded clearing activities"[32] by a banking entity that is a member of a clearing agency, a DCO, or a "designated financial market utility" ("DFMU").[33]

[27] However, this requirement is not intended to prevent banking entities from recognizing profits (or losses) on securities held for liquidity management purposes.

[28] To ensure sufficient flexibility to respond to liquidity needs arising from changes in the economy, a banking entity should address a range of liquidity circumstances in its plan, and provide a mechanism for periodically reviewing and revising it.

[29] For example, this exclusion allows a banking entity that is an SEC-registered broker-dealer to take action to address failures to deliver arising from its own trading activity or the trading activity of its customers, as it may be required to do under SEC regulation. In addition, buy-in procedures of a clearing agency, securities exchange or national securities association may require a banking entity to deliver securities if a party with a "fail to receive" position takes certain action.

[30] This exclusion is important for myriad common situations. For example, it enables banking entities, including SEC-registered broker-dealers, to continue to take possession of, and liquidate, margined collateral following a customer's default or failure to meet a margin call, in accordance with applicable regulations. Similarly, a banking entity that is a CFTC-registered swap dealer or SEC-registered security-based swap dealer may take, hold and exchange any margin collateral as counterparty to a cleared or uncleared swap or security-based swap transaction, in accordance with applicable regulations. This exclusion also allows banking entities to comply with existing regulations regarding the divestiture of collateral taken in satisfaction of a debt.

[31] For this purpose, a DCO is: (i) an entity registered as a DCO under Section 5b of the CEA or that, pursuant to CFTC regulation, is exempt from such registration; or (ii) a foreign DCO that, pursuant to CFTC regulation, is permitted to clear for a foreign board of trade that is registered with the CFTC. "Clearing agency" has the same meaning as in Section 3(a)(23) of the '34 Act.

B. What Proprietary Trading Is Prohibited?

Consistent with the statutory language of the Volcker Rule, the Final Rule prohibits a banking entity from engaging in *any* proprietary trading, unless the particular trading activity at issue is permitted under one of several specific exemptions to the general ban (as discussed in the following section). Notwithstanding such exemptions, however, any activity or transaction will always be precluded if it:

1. Involves a "material conflict of interest" between the banking entity and its clients, customers or counterparties;

   Unless, prior to engaging in such activity or transaction, the entity: (i) gives the other party clear and effective disclosure of the conflict and the opportunity to negate or substantially mitigate its impact; or (ii) the entity has information barriers, memorialized in written policies and procedures, that are reasonably designed to prevent a materially adverse effect on the other party (except where the entity knows, or should reasonably know, that the barriers are unlikely to prevent a particular materially adverse effect);

2. Materially exposes the entity to an asset, group of assets or trading strategy that would significantly increase the likelihood of: (i) substantial loss by the banking entity; or (ii) a threat to U.S. financial stability; or (iii) a threat to the safety and soundness of the banking entity or U.S. financial stability.

C. What Proprietary Trading Activities Are Permitted?

The exemptions to the Final Rule's ban on proprietary trading are discussed below. A banking entity that wishes to avail itself of one or more of these exemptions (other than the exemption for U.S. government obligations discussed below) must establish a compliance program designed to ensure and monitor compliance with the Final Rule.[34] However, the complexity of the required program varies depending on the size of the entity and the volume of its trading activity.[35] Finally, entities with $10 billion or more in trading assets and liabilities (calculated as discussed above) will also be subject to certain reporting requirements.

1. Underwriting Activities

   (a) Proprietary trading conducted by a "trading desk"[36] of a banking entity as part of the entity's underwriting activities is permitted, so long as:

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[32] The Final Rule defines "excluded clearing activity" as any purchase or sale: (i) necessary to correct trading errors made by, or on behalf of, a customer with respect to customer transactions that are cleared, provided that such transaction is conducted in accordance with the CEA, CFTC regulations, and/or the rules of the DCO, clearing agency or DFMU, as applicable; (ii) in connection with the management of a default or threatened imminent default of a customer, provided that the transaction is conducted in accordance with the CEA, CFTC regulations, and/or the rules of the DCO, clearing agency or DFMU, as applicable; (iii) in connection with the management of a default or threatened imminent default of a clearing agency, DCO, DFMU or any member of any of the foregoing (while the Final Rule references only explicitly employs the "imminent" qualifier with regard to the threatened default of a clearinghouse or FMU member, the Preamble to the Final Rule appears to indicate that the same standard applies with regard to a clearing agency, DCO or DFMU); or (iv) required by the rules or procedures of a clearing agency, DCO or DFMU to mitigate its risk resulting from the clearing by a member of security-based swaps that reference the member or an affiliate of the member.

[33] As defined in Section 803(4) of the Dodd-Frank Act.

[34] Moreover, as discussed below, the exemptions for underwriting, market-making and risk-mitigation hedging activities each impose additional components to the requisite compliance program.

[35] A banking entity with total consolidated assets of $10 billion or less (as reported at the end of the previous two calendar years) may satisfy this compliance program obligation by simply including in its *existing* policies and procedures appropriate references to the Volcker Rule and Final Rule, as applicable.

[36] Defined as "the smallest discrete unit of organization of a banking entity that purchases or sells financial instruments for the trading account of the banking entity or an affiliate thereof." The focus is on functionality rather than legal status or corporate structure. Thus, a trading desk may include employees of multiple affiliates or book trades in multiple affiliates. In the underwriting context, a "trading desk" encompasses what is commonly thought of as an underwriting desk and would not necessarily be an active market participant that engages in frequent trading activities.

(b) The entity is acting as an "underwriter" for a "distribution" of securities and the desk's "underwriting position" is related to such distribution;[37]

(c) The banking entity is licensed or registered to engage in such activity, in accordance with applicable law;[38]

(d) The amount and type of securities in the desk's underwriting position[39] are designed not to exceed the reasonably expected near-term demands of clients, customers or counterparties,[40] *and* reasonable efforts are made to sell or reduce the position within a reasonable period, taking into account the liquidity, maturity and depth of the market for the relevant security;

(e) The compensation arrangements of relevant employees are designed not to reward or incentivize prohibited proprietary trading;[41] and

(f) The entity has established and enforces an internal compliance program, as required by the Final Rule, that is reasonably designed to ensure compliance with the requirements of this underwriting exemption, including written policies and procedures, internal controls, analysis and independent testing identifying and addressing:

  (i) The products, instruments or exposures each desk may purchase, sell or manage as part of its underwriting activities;

  (ii) Limits for each desk, based on the nature and amount of its underwriting activities, including the reasonably expected near term demands of clients, customers or counterparties, on the: (i) amount, types and risk of its underwriting position; (ii) level of risk exposures arising from the position; and (iii) period of time a security may be held;

  (iii) Internal controls and ongoing analysis of each desk's compliance with its limits; and

  (iv) Authorization procedures (including escalation procedures) that require: (i) review and approval of any trade that would exceed a desk's limit; (ii) demonstrable analysis of the basis for any limit increase (even if only temporary); and (iii) independent review of such analysis and approval.

2. Market-Making Activities

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[37] For this purpose, an "underwriter" is a person who has: (i) agreed with an issuer or selling security holder to purchase securities for distribution, engage in a distribution of securities, or manage a distribution of securities for or on behalf of the issuer or selling security holder; or (ii) agreed to participate or is participating in a distribution of such securities for or on behalf of the issuer or selling security holder. A "distribution" is an offering of securities that is: (i) made pursuant to an effective registration statement under the Securities Act of 1933 (the "'33 Act"); or (ii) distinguished from ordinary trading transactions by the presence of special selling efforts and selling methods (such as delivering sales documents or conducting road shows), whether or not the offering is subject to registration under the '33 Act. An "underwriting position" is the long or short positions held by a banking entity or its affiliate, and managed by a particular trading desk, in connection with a distribution for which the entity or affiliate is acting as an underwriter.

[38] However, not all entities engaged in activity under this exemption would have an obligation to be licensed or registered under applicable law.

[39] It is important to note that the underwriting exemption's requirements pertaining to a trading desk's underwriting position apply on a *distribution-by-distribution* basis, rather than on individual transactions. The desk may not aggregate positions acquired in connection with multiple distributions to determine its underwriting position. However, it may have more than one underwriting position at a particular point in time if the banking entity is acting as an underwriter for more than one distribution. A desk's underwriting position can include securities held at different affiliates if the banking entity maintains readily available records that identify any related positions held at an affiliate that are being included in its desk's underwriting position for purposes of this exemption.

[40] For a banking entity that acts as a primary dealer (or functional equivalent) for a sovereign government, the sovereign government and its central bank would each fit within this category for the purpose of this underwriting exemption, as well as the market making exemption discussed below.

[41] The Agencies explained that, although a banking entity relying on the underwriting exemption may appropriately take into account revenues from price movements to the extent that such revenues reflect the effectiveness with which personnel have managed underwriting risk, the entity should provide compensation incentives that primarily reward customer revenues and effective customer service.

Proprietary trading related to the market-making activity of a banking entity is permitted, so long as:

(a) The trading desk[42] that establishes and manages the "financial exposure":[43] (i) routinely stands ready to purchase and sell financial instruments related to its financial exposure; and (ii) is willing and available to quote, purchase and sell, or otherwise enter into long and short positions in such instruments for its own account, in commercially reasonable amounts and throughout market cycles on a basis appropriate for the liquidity, maturity and depth of the market for such instruments;[44]

(b) The entity is licensed or registered to engage in such activity, in accordance with applicable law;[45]

(c) The amount, types and risks of the instruments in the desk's "market-maker inventory"[46] are designed not to exceed, on an ongoing basis, the reasonably expected near-term demands of clients, customers or counterparties,[47] based on: (i) the liquidity, maturity and depth of the market for the relevant instruments; and (ii) demonstrable analysis of historical demand, current inventory, and market and other factors regarding the amount, types, and risks of or associated with the relevant instruments, including through block trades;

(d) The compensation arrangements of relevant employees are designed not to reward or incentivize prohibited proprietary trading;[48]

(e) The entity has established and enforces an internal compliance program, as required by the Final Rule, that (as under the underwriting exemption) is reasonably designed to ensure compliance with the requirements of this underwriting exemption, including written policies and procedures, internal controls, analysis and independent testing identifying and addressing:

    (i) The financial instruments each desk stands ready to purchase and sell, as part of its market-making activities;

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[42] In the market-making context, the Agencies expect that a trading desk would be managed and operated as an individual unit and should reflect the level at which the profit and loss of market-making traders is attributed. As explained above, the location of individual traders is not dispositive for purposes of determining whether the traders may all belong to a single desk.

[43] For this purpose, "financial exposure" means the aggregate risks of the financial instruments and any associated loans, commodities, or foreign exchange or currency held by an entity (or an affiliate) and managed by a particular trading desk as part of the desk's market making-related activities.

[44] This requirement would not be satisfied, for example, if the desk only provides wide quotations on one or both sides of the market relative to prevailing market conditions or is only willing to trade on an irregular basis. It is important to note that the Final Rule's standard for exempted market-making is similar, but not identical, to activity that is considered market-making for purposes of other laws or regulations, such as the U.S. securities laws. In addition, the Agencies noted that a banking entity acting as an underwriter would continue to be treated as an underwriter for purposes of U.S. securities laws, regardless of whether it is able to meet the terms of the market-making exemption for its activities.

[45] However, not all entities engaged in activity under this exemption would have an obligation to be licensed or registered under applicable law.

[46] Defined as all of the positions in the instruments for which the desk stands ready to make a market in accordance with exemption that are managed by the trading desk, including open positions or exposures arising from open transactions. Like the underwriting exemption, the market-making exemption does not utilize a transaction-by-transaction approach, but instead focuses on two related aspects of market-making activity: a trading desk's "market-maker inventory" and its overall "financial exposure."

[47] For this purpose, another banking entity will not constitute a client, customer or counterparty if it has trading assets and liabilities of $50 billion or more, unless: (i) the trading desk documents how and why a particular unit of the other entity should be treated as a client, customer or counterparty of its market making-related services; or (ii) the purchase or sale by the desk is conducted anonymously on an exchange (or similar facility) that permits trading by a broad range of market participants. Furthermore, the Agencies explained that, for this purpose, an exchange-traded fund ("ETF") and any market participants seeking to purchase ETF shares will be considered clients, customers or counterparties of a banking entity that acts as an authorized participant for the ETF.

[48] As with the underwriting exemption, a banking entity relying on the market making exemption may appropriately take into account revenues from price movements to the extent that such revenues reflect the effectiveness with which personnel have managed retained principal risk, but it should provide compensation incentives that primarily reward customer revenues and effective customer service.

(ii) Limits for each desk, based on the nature and amount of its market making-related activities, including the reasonably expected near-term demands of clients, customers or counterparties, on the: (i) amount, types and risk of its market-maker inventory or the products, instruments and exposures used for risk-management purposes; (ii) level of exposure to relevant risk factors arising from financial exposure; and (iii) period of time an instrument may be held;

(iii) Internal controls and ongoing analysis of each desk's compliance with its limits;

(iv) Risk-mitigation policies, including: (i) actions the desk will take to significantly reduce or mitigate promptly the risks of its financial exposure consistent with the aforementioned limits; (ii) products, instruments and exposures permissible to use for risk-management purposes; (iii) techniques and strategies permissible to manage the risks of its market making-related activities and inventory; and (iv) processes, strategies and personnel responsible for ensuring that the actions taken to mitigate risk are, and continue to be, effective;[49] and

(v) Authorization procedures (including escalation procedures) that require: (i) approval of any trade that would exceed a desk's limit; (ii) demonstrable analysis of the basis for any limit increase (even if only temporary); and (iii) independent review of such analysis and approval; and

(f) To the extent that any limit identified above is exceeded, the desk takes action to comply with the limit as promptly as possible thereafter.

3. Risk-Mitigating Hedging

The prohibition on proprietary trading does not apply to the risk-mitigating hedging activities of a banking entity in connection with, and related to, *individual or aggregated*[50] positions, contracts or other holdings of the entity, so long as:

(a) The entity has established and enforces an internal compliance program, as required by the Final Rule, that (similar to the foregoing exemptions) is reasonably designed to ensure compliance with the requirements of this risk-mitigating hedging exemption, including:

(i) Reasonably designed written policies and procedures regarding the positions, techniques and strategies that may be used for hedging, including which positions, contracts or other holdings a particular trading desk may use, as well as position and aging limits with respect to such holdings;

(ii) Internal controls and ongoing monitoring, management and authorization procedures, including relevant escalation procedures; and

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[49] It should be noted that such market-making-related hedging activity need not separately comply with the risk-mitigating hedging exemption discussed later herein. In addition, a desk engaged in market-making-related activities may direct another organizational unit of the banking entity or an affiliate to execute a risk-mitigating transaction on the desk's behalf. However, such other unit may rely on the market making exemption for these purposes only if: (i) the unit acts in accordance with the desk's market-making risk management policies and procedures; and (ii) the risk-mitigating position is attributed to the desk's, rather than the unit's, financial exposure and is included in the desk's daily profit and loss calculation. Otherwise, the unit must comply with the requirements of the hedging exemption for such activity.

[50] Like the statutory language of the Volcker Rule, the Final Rule explicitly permits hedging of aggregated positions under this exemption, as long as such activity relates to identifiable risks related to specific holdings. Accordingly, the Agencies explained that exempted hedging activity cannot be designed to: (i) reduce risks associated with the entity's assets or liabilities generally, general market movements or broad economic conditions; (ii) profit in the case of a general economic downturn; (iii) counterbalance revenue declines generally; or (iv) otherwise arbitrage market imbalances unrelated to the risks resulting from the positions lawfully held by the entity.

(iii) The conduct of analysis, including correlation analysis, and independent testing designed to ensure that the positions, techniques and strategies that may be used for hedging may reasonably be expected to demonstrably reduce or otherwise significantly mitigate the specific, identifiable risk being hedged (*and* such correlation analysis demonstrates that the hedging activity indeed achieves the foregoing objective[51]);[52]

(b) The risk-mitigating hedging activity:

(i) Is conducted in accordance with the foregoing written policies, procedures and internal controls;

(ii) Is designed (at its inception and at the time of any adjustments) to reduce or otherwise significantly mitigate (*and* demonstrably reduces or otherwise significantly mitigates) one or more *specific, identifiable risks*, including market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, commodity price risk, basis risk or similar risks, arising in connection with and related to *identified* positions, contracts or other holdings of the entity (based on the relevant facts and circumstances);[53]

(iii) Does not give rise, at its inception, to any significant new or additional risk that is not itself hedged contemporaneously in accordance with this exemption;

(iv) Is subject to ongoing monitoring and management that:

(1) Is consistent with the written hedging policies and procedures discussed above;

(2) Is designed to reduce or otherwise significantly mitigate (*and* demonstrably reduces or otherwise significantly mitigates) the specific, identifiable risks that develop over time from the risk-mitigating hedging activities undertaken under this section and the underlying holdings of the entity (based on the relevant facts and circumstances); and

(3) Requires ongoing recalibration of the hedging activity to ensure that it satisfies the requirements of (i), (ii), (iii) and (iv)(1) and (2) above, and is not prohibited proprietary trading;

(c) The compensation arrangements of relevant employees are designed not to reward or incentivize prohibited proprietary trading;[54] and

(d) In certain instances (as discussed below), the banking entity must, contemporaneously with a purchase or sale, document (at a minimum): (i) the specific, identifiable risk(s) that the transaction is designed to reduce; (ii) the specific risk-mitigating strategy that the transaction

[51] However, the Agencies explicitly recognized that demonstrating correlation may not be possible in certain circumstances, in which case such analysis should explain why not and also how the position, technique or strategy is designed to reduce or significantly mitigate risk and how its efficacy can be demonstrated without correlation.

[52] The requisite scope and level of detail of the required compliance program will vary depending on the size, activities and complexity of the banking entity at issue.

[53] As explained by the Agencies, the Final Rule allows for dynamic hedging, because the risks from a permissible position may change over time, new risks may emerge, and hedges may become less effective over time in addressing the related risk. Anticipatory hedging is also permitted, so long as it is also risk reducing and not impermissible proprietary trading. If an anticipated risk does not materialize within a limited time period contemplated when the hedge is entered into, the banking entity would be required to extinguish the anticipatory hedge or otherwise demonstrably reduce its risk as soon as reasonably practicable.

[54] For instance, the Agencies indicated that a compensation arrangement that incentivizes an employee to exceed the potential losses associated with the risks of the underlying position, rather than reduce such risks, would also likely violate this requirement.

is designed to fulfill; and (iii) the desk or other unit that is establishing and responsible for the hedge.[55]

The foregoing documentation requirements apply to any purchase or sale made under this risk-mitigating hedging exemption that is established:

(i) By a different trading desk than the one establishing or responsible for the underlying holdings whose risks are being hedged;

(ii) By the desk establishing or responsible for the underlying holdings, but effected through an instrument, exposure, technique or strategy that is not specifically identified in the desk's written policies and procedures (discussed above) as permissible for hedging; or

(iii) To hedge aggregated positions across two or more trading desks.

4. Trading in U.S. Government Obligations

A banking entity may engage in proprietary trading of any financial instrument (but not any derivative thereof[56]) that is:

(a) An obligation of, or issued or guaranteed by, the United States;

(b) An obligation, participation or other instrument of, or issued or guaranteed by, a U.S. agency, Ginnie Mae, Fannie Mae, Freddie Mac, a Federal Home Loan Bank, Farmer Mac or a Farm Credit System institution chartered under and subject to the provisions of the Farm Credit Act of 1971;

(c) An obligation of any U.S. state or territory, any political subdivision of either, or any agency or instrumentality of any of the foregoing (including any municipal security); or

(d) An obligation of the FDIC, or any entity formed by or on behalf of the FDIC to facilitate the disposal of assets acquired or held by the FDIC in its corporate capacity or as conservator or receiver under the Federal Deposit Insurance Act or Title II of the Dodd-Frank Act.

5. Trading in Non-U.S. Government Obligations

A banking entity may engage in proprietary trading of any financial instrument that is an obligation of, or issued or guaranteed by, a non-U.S. sovereign (including any multinational central bank of which such sovereign is a member), or any agency or political subdivision of such sovereign (but not any derivative of such an instrument),[57] under the following circumstances:

(a) U.S. Operations of Non-U.S. Banking Entities: The "U.S. operations" of a non-U.S. banking entity that is not ultimately controlled by a U.S. banking entity[58] may engage in proprietary trading of such an instrument, if:

[55] Such records must be retained for at least five years (or such longer period as required by other applicable law) in a form that allows the entity to promptly produce them upon the request of its primary federal regulator.

[56] Thus, this exemption does not permit a banking entity to engage in proprietary trading of derivatives of U.S. government or agency obligations. However, such activity may qualify for the market-making or risk-mitigating hedging exemptions.

[57] However, as noted above in the context of U.S. government obligations, trading in such derivatives may qualify under another exemption.

[58] A "non-U.S. banking entity" is a banking entity organized under the laws of a non-U.S. sovereign, whereas a "U.S. banking entity" is organized under the laws of the United States or any state, territory or commonwealth thereof. For this purpose, the "U.S operations" of a non-U.S. banking

The instrument is an obligation of, or issued or guaranteed by, the non-U.S. sovereign under whose laws the entity (or its control party) is organized (or by any: (i) agency or political subdivision of such sovereign; or (ii) multinational central bank of which such sovereign is a member); and

(b) The entity acting as principal is not an FDIC-insured depository institution.

6. Non-U.S. Operations of U.S. Banking Entities

A non-U.S. banking entity ultimately controlled by a U.S. banking entity may engage in proprietary trading of such an instrument, if:

(a) The non-U.S. banking entity is regulated by its home sovereign as a bank[59] or a securities dealer;

(b) The instrument is an obligation of, or issued or guaranteed by, the sovereign under whose laws the entity is organized (or by any: (i) agency or political subdivision of such sovereign; or (ii) multinational central bank of which such sovereign is a member); and

(c) The instrument is owned by the entity and not financed by an affiliate that is either organized or located in the United States.

7. Trading on Behalf of Customers

(a) The prohibition on proprietary trading does not apply to the purchase or sale of a financial instrument by a banking entity on behalf of its customers in the follow two contexts:

(i) Fiduciary Transactions: Where the entity is acting as trustee or in a similar fiduciary capacity, so long as: (i) the transaction is conducted for the account of, or on behalf of, a customer; and (ii) the entity does not have or retain beneficial ownership of the instrument;[60] and

(ii) Riskless Principal Transactions: Where the entity is acting as riskless principal in a transaction in which it, after receiving an order to purchase (or sell) the instrument from a customer, purchases (or sells) the instrument for its own account to offset a contemporaneous transaction with the customer.

8. Trading by a Regulated Insurance Company

(a) The prohibition on proprietary trading does not apply to the purchase or sale of a financial instrument by a banking entity that is a regulated insurance company (or an affiliate thereof), if the transaction:

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entity would include: (i) any U.S. branch or agency of the entity; and (ii) any U.S. banking entity controlled by the non-U.S. banking entity. While this exemption is available only for the U.S. operations of non-U.S. banking entities, non-U.S. banking entities have a far broader exemption available for their non-U.S. operations, one that is not limited to sovereign obligations (as discussed later herein).

[59] To qualify as a "bank" for this purpose, the institution's ordinary course of business must include substantial deposit-taking and it must have the ability to accept demand deposits.

[60] It is not entirely clear why such a transaction would be considered proprietary trading in the absence of this exemption (i.e., why it would not be excluded from the definition as a situation where the entity was not acting *as principal*, such as when it as agent, broker or custodian). However, this exemption was contained in the statutory language of the Volcker Rule.

(i) Is conducted solely for the general account of the insurance company or for one or more separate accounts established by the insurance company; and

(ii) Complies with the insurance law of the jurisdiction in which the insurance company is domiciled (and the appropriate federal banking agencies have not determined that such law is insufficient to protect the banking entity's safety and soundness or U.S. financial stability).

D. Non-U.S. Trading Activity of Non-U.S. Banking Entities

1. Certain eligible non-U.S. banking entities are permitted to engage in proprietary trading of any financial instruments, provided the trading decisions and principal risks occur and are held outside the United States (as discussed below).

2. Eligible Non-U.S. Banking Entities: A non-U.S. banking entity is eligible to use this exemption, if:

(a) The entity is not directly or indirectly controlled by a U.S. banking entity;[61] and

(b) If the entity is a "foreign banking organization" under the Board's Regulation K, it qualifies for the exemption;[62] or

(c) If the entity is not a "foreign banking organization" under the Board's Regulation K, it must satisfy, on a fully-consolidated basis, at least two of the following:

(i) Its total assets held outside the United States exceed those held in the United States;

(ii) Its total revenues from its non-U.S. business exceed those from its U.S. business; and

(iii) Its total net income from its non-U.S. business exceed that from its U.S. business.

3. Eligible Trading Activity: An eligible non-U.S. banking entity may engage in proprietary trading under this exemption only if:

(a) The entity (or office thereof) acting as principal (and that makes the decision to engage in the transaction, if different) is not organized or located in the United States;[63]

(b) No personnel of the entity (or an affiliate) who arrange, negotiate, execute or make the decision to execute such transaction are located in the United States;[64]

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[61] Thus, non-U.S. subsidiaries or non-U.S. offices of a U.S. banking entity may not take advantage of this exemption.

[62] Under Regulation K, a "foreign banking organization" is a foreign bank that operates a branch office, agency office, commercial lending company, bank subsidiary or Edge corporation in the United States, or any subsidiary of such an institution. To constitute a "qualifying foreign banking organization," it must satisfy two tests (unless otherwise permitted by the Board). First, it must satisfy at least two of the following: (i) its banking assets held outside the United States exceed its total worldwide nonbanking assets; (ii) its revenues derived from the business of banking outside the United States exceed its total revenues derived from its worldwide nonbanking business; and (iii) its net income derived from the business of banking outside the United States exceeds its total net income derived from its worldwide nonbanking businesses. Second, it must satisfy at least two of the following: (i) its banking assets held outside the United States exceed its banking assets held in the United States; (ii) its revenues derived from the business of banking outside the United States exceed its revenues derived from the business of banking in the United States; and (iii) its net income derived from the business of banking outside the United States exceeds its net income derived from the business of banking in the United States.

[63] For this purpose, any U.S. office of a non-U.S. bank (or any subsidiary of such office) is located in the United States, but the bank itself is not.

[64] Thus, for example, personnel in the United States cannot solicit or sell to or arrange for trades conducted under this exemption. However, the Agencies explained that personnel that engage in back-office functions, such as clearing and settlement of trades, could be located in the United States.

(c) The transaction (including any risk-mitigating hedging transaction related thereto) is not accounted for as principal directly, or on a consolidated basis by, any branch or affiliate that is organized or located in the United States;

(d) No financing for the transaction is provided, directly or indirectly, by any such branch or affiliate; and

(e) The transaction is not conducted with or through any entity that is, or is controlled by, or acting on behalf of, or at the direction of, any other entity that is, organized or located in the United States (collectively, a "U.S. entity"), other than:

(i) A transaction with the foreign operations of a U.S. entity if no personnel of such entity that are located in the United States are involved in the arrangement, negotiation or execution of such purchase or sale;

(ii) A transaction with an "unaffiliated market intermediary"[65] acting as principal, provided the transaction is promptly cleared and settled through a clearing agency or DCO acting as a central counterparty; or

(iii) A transaction through an unaffiliated market intermediary acting as agent, provided the transaction is conducted anonymously on an exchange or similar trading facility[66] and is promptly cleared and settled through a clearing agency or DCO acting as a central counterparty.

E. Timing

1. Conformance Date: Banking entities had until July 21, 2015 to conform their activities to the Final Rule.[67] This deadline represented a one-year extension of the Volcker Rule's conformance period, which the Board granted simultaneously with the issuance of the Final Rule.[68] However, as noted above, banking entities with $50 billion or more in trading assets and liabilities must have complied with certain reporting obligations by June 30, 2014.[69]

2. Conformance Period Obligations: Up until July 21, 2015, each banking entity was expected to engage in "good-faith efforts" to conform its activities and investments to the requirements of the Volcker Rule and the Final Rule. The Board explained that such good faith efforts should include "evaluating the extent to which the banking entity is engaged in activities and investments that are covered by [the Volcker Rule] and the [Final Rule], as well as developing and implementing a conformance plan that is appropriately specific about how the banking entity will fully conform all of its covered activities by the end of the conformance period. In addition, entities that have stand-

[65] For purposes of this exemption, an "unaffiliated market intermediary" is an unaffiliated entity, acting as an intermediary, that is: (i) a broker or dealer registered with the SEC under Section 15 of the '34 Act; (ii) a swap dealer registered with the CFTC under Section 4s of the CEA; (iii) a security-based swap dealer registered with the SEC under section 15F of the '34 Act or exempt from registration; or (iv) a futures commission merchant registered with the CFTC under Section 4f of the CEA (or exempt from any of the foregoing registration obligations or excluded from regulation as any of the foregoing).

[66] The Agencies have indicated that a non-U.S. banking entity *would* be in compliance with this requirement even if the counterparty to its trade happened to be an affiliated entity, so long as it traded anonymously through an unaffiliated market intermediary on an exchange.

[67] Notwithstanding the foregoing, a company that was not a banking entity on July 21, 2010 must bring its activities into conformance before the later of: (i) July 21, 2015; or (ii) two years after the date on which the company becomes a banking entity.

[68] In doing so, the Board indicated that it will continue to monitor developments to determine whether additional extensions of the conformance period would be in the public interest and consistent with the statute.

[69] Banking entities with $25 billion or more in trading assets and liabilities and banking entities with $10 billion or more in trading assets and liabilities would be required to comply with reporting obligations beginning on April 30, 2016 and Dec. 31, 2016, respectively.

alone proprietary trading operations are expected to promptly terminate or divest those operations."

3. Potential Extensions: Under the Volcker Rule, the Board is empowered to grant a banking entity up to three one-year extensions. As indicated above, the Board has used one of those potential extensions to grant the entire industry a one-year delay of the conformance date. Thus, a banking entity could potentially seek up two additional one-year extensions.[70] However, given the Board's stated expectations, it would appear that an extension for non-exempt proprietary trading activities would be unusual.

IV. Summary of Final Volcker Rule Regulation: Fund Activities

On Dec. 10, 2013, the Agencies issued a final rule (the "Final Rule") implementing Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which is commonly referred to as the "Volcker Rule."[71] The Volcker Rule restricts the proprietary trading and private investment fund activities of U.S. banks and their affiliates, as well as foreign banks with a branch or agency office in the United States and their affiliates (collectively, "banking entities").[72]

The text of the Final Rule is more than 70 pages long, while the supplemental guidance issued with it numbers nearly 900 pages and contains more than 2,800 footnotes. While the Final Rule is largely similar to the Notice of Proposed Rulemaking issued by the Agencies in 2011 (the "Proposed Rule"),[73] it does contain numerous important modifications from the Proposed Rule. As discussed below, banking entities generally have until July 21, 2015 to comply with the Final Rule's restrictions.

This section analyzes the Final Rule as it would affect a banking entity's investments in, or sponsorship of, private investment funds. In this regard, the regulation has two parts. First, a banking entity is generally barred from acquiring or retaining, "as principal," an "ownership interest" in a "covered fund," subject to certain exceptions. Second, a banking entity may no longer "sponsor" any "covered fund," unless it abides by a series of new requirements (or the sponsorship falls within an exception for non-U.S. activity).

A. Prohibition on Fund Investments

1. What Is a "Covered Fund"?

(a) As noted above, the Final Rule's prohibition on fund investments only pertains to "covered funds." Under the Final Rule, a "covered fund" includes:

(b) Hedge or Private Equity Funds: The primary component of the definition of "covered funds" is any issuer that would be an investment company under the Investment Company Act of 1940

[70] Any extension request must be submitted in writing at least 180 days in advance and must contain a detailed explanation of the banking entity's plan for divesting or conforming the activity, as well as an analysis of numerous factors required by the Board.

[71] The Agencies, with the exception of the CFTC, issued a joint final rule release. The CFTC issued a separate, but virtually identical release.

[72] For the purposes of the Final Rule, the term "affiliate" means any company that controls, is controlled by or is under common control with another company. A company controls another company if: (i) the company directly or indirectly or acting through one or more other persons owns, controls or has power to vote 25 percent or more of any class of voting securities of the company; (ii) the company controls in any manner the election of a majority of the directors or trustees of the other company; or (iii) the Board determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the company. For purposes of the Final Rule, the term "affiliate" would not include any affiliated entity that is: (i) a covered fund; (ii) a portfolio company held by a bank, pursuant to its merchant banking authority; or (iii) a "portfolio concern" (as defined by 13 C.F.R. § 107.50) controlled by a "small business investment company" ("SBIC") (as defined in the Small Business Investment Act of 1958).

[73] The Agencies, with the exception of the CFTC, issued the Proposed Rule on Oct. 11, 2011. The CFTC issued its version on Feb. 14, 2012.

("'40 Act") but for the exemptions contained in Sections 3(c)(1) and 3(c)(7) therein ("3(c)(1)/3(c)(7) funds");[74] and

(c) Commodity Pool Equivalents: Certain Commodity Pools that are similar to 3(c)(1)/3(c)(7) funds are also included, specifically pools for which:

(i) The commodity pool operator ("CPO") has claimed an exemption under CFTC Rule 4.7;[75] or

(ii) The CPO is registered with the CFTC and the pool is primarily held by qualified eligible participants ("QEPs") and has not been publicly offered to non-QEPs.[76]

(d) Equivalent Non-U.S. Funds (if banking entity is U.S. or U.S.-controlled): Moreover, for any U.S. banking entity (or any non-U.S. banking entity that is directly or indirectly controlled by a U.S. banking entity) a "covered fund" would also include any issuer that:

(i) Is organized or established outside the United States;

(ii) Offers and sells its ownership interests outside the United States; and

(iii) Is, or holds itself out as, a vehicle for primarily investing or trading in securities (a "foreign fund");

(iv) *Unless* such foreign fund, were it subject to U.S. securities laws, could rely on an exemption from the '40 Act other than those contained in Section 3(c)(1) or 3(c)(7) therein.

(v) In contrast, a non-U.S. banking entity that is not directly or indirectly controlled by a U.S. banking entity would not have to treat a non-U.S. fund that meets the foregoing criteria as a covered fund (but, for this purpose, a U.S. branch or agency office of a non-U.S. bank would be treated as a U.S. banking entity).[77]

2. What Entities Are Excluded from the 'Covered Fund' Definition?

The following types of issuers do not constitute covered funds under the Final Rule, even where they otherwise would fit the definition:

(a) Certain Non-U.S. Public Funds: A public fund organized or established outside the United States, provided that:

(i) It is authorized to offer and sell ownership interests to retail investors in its home jurisdiction; and

[74] This would capture nearly all entities currently thought of as hedge funds or private equity funds. However, the Final Rule appears to make clear that an issuer that can rely on exemptions under the '40 Act other than Section 3(c)(1) or 3(c)(7), such as a real estate fund relying on Section 3(c)(5), will not be treated as a covered fund, even if it may also rely on Section 3(c)(1) or 3(c)(7).

[75] The Agencies chose to include "Rule 4.7" pools in the definition since they are most similar to 3(c)(1)/3(c)(7) funds, as they are only offered to investors who meet certain heightened qualification standards.

[76] The Agencies chose to include such funds so as to prevent a CPO from choosing full CPO compliance, rather than rely on Rule 4.7 (even though eligible to do so), simply to keep the pool outside the scope of the Final Rule.

[77] For example, such a fund would be a covered fund with respect to a U.S. banking entity that sponsors the fund, but not be a covered fund with respect to a non-U.S. banking entity that invests in the fund (provided the entity is not U.S.-controlled). This bifurcated treatment of such non-U.S. funds, depending on the jurisdictional nature of the banking entity involved, is a significant change from the Proposed Rule and was meant to limit the extraterritorial effect of the Volcker Rule.

(ii) It sells such interests "predominantly"[78] through one or more public offerings outside the United States that: (i) comply with all applicable requirements in the applicable jurisdiction; (ii) are not restricted based on investor net worth; and (iii) include the filing of publicly available disclosure documents.

(iii) Moreover, *for any U.S. banking entity (or any non-U.S. banking entity that is directly or indirectly controlled by a U.S. banking entity)* to rely on this exemption to "sponsor" (as defined below) a non-U.S. public fund, the fund's ownership interests must be sold "predominantly" to persons other than: (i) the banking entity; (ii) the issuer; (iii) their affiliates; or (iv) employees or directors of such entities.[79]

(b) Certain Non-Funds: Three types of entities that would not normally be thought of as funds, but could otherwise sometimes fall within the broad definition of "covered funds," include:

(i) Wholly Owned/Nearly Wholly Owned Subsidiaries: An entity that is at least 95-percent owned by a banking entity, provided that any amount not owned by the entity is held by: (i) employees or officers (not to exceed 5 percent); or (ii) third parties (not to exceed 0.5 percent) where such third-party investor is needed to establish corporate separateness or address bankruptcy or similar concerns;

(ii) Joint Ventures: A joint venture ("JV") between a banking entity and others, provided: (i) there are no more than 10 unaffiliated co-venturers; and (ii) the JV vehicle does not invest, or hold itself out as investing, in securities for resale, but otherwise engages in activity that is permissible for the banking entity; and

(iii) Acquisition Vehicles: An issuer formed solely for the purpose of engaging in a bona fide acquisition or merger, which exists only for such period as necessary to effectuate such transaction.[80]

(c) Foreign Pension Funds: A broad-based plan, fund or program organized and administered outside the United States to provide retirement or similar benefits, provided that it is: (i) subject to regulation in its home jurisdiction; and (ii) established for benefit of citizens or residents of one or more non-U.S. sovereigns (or subdivisions thereof).

(d) Insurance Company Separate Accounts: Provided that no other banking entity besides the insurance company shares in the profits or losses of such account.

(e) Bank-Owned Life Insurance: Provided that the banking entity that purchases the policy does not: (i) control the investment decisions of the separate account; or (ii) participate in the profit or losses of such account, except in accordance with applicable supervisory guidance.

(f) Loan Securitizations: An issuer of asset-backed securities ("ABS"), provided that its assets are solely comprised of:

[78] For the purposes of this exclusion "predominantly" means 85 percent or more of the fund's ownership interests.

[79] Accordingly, unlike with non-U.S. equivalents of 3(c)(1)/3(c)(7) funds, U.S. banking entities (and non-U.S. banking entities controlled by a U.S. banking entity) may be able to invest in or sponsor a non-U.S. public fund without such activity being subject to the Final Rule. However, the Agencies intend to monitor U.S. banking entities' investments in non-U.S. public funds to ensure such funds are not used to evade the Volcker Rule.

[80] However, an acquisition vehicle that survives a transaction may then be eligible for either of the two preceding exclusions.

(i) Loans (defined as any loan, lease, extension of credit or receivable, that is not a security or derivative);

(ii) Any rights or other assets: (i) related or incidental to acquiring or holding the loans; or (ii) designed to assure the servicing or timely delivery of proceeds to the security holders ("Permitted Assets");

(iii) Interest rate or foreign exchange derivatives that are directly related to the loans or Permitted Assets held by the issuer or related ABS and are specifically designed to reduce the interest rate or foreign exchange risks related thereto;

(iv) Special units of beneficial interest and collateral certificates issued by a special purchase vehicle ("SPV"), provided that: (i) the SPV does not hold any assets impermissible for the issuer to hold; (ii) the interest or certificate is used solely to transfer to the issuer the economic risks and benefits of assets permissible for the issuer to hold (and does not transfer any interest in any other exposure); (iii) the interest or certificate is created solely to satisfy legal requirements or facilitate the structuring of the securitization; and (iv) both the SPV and the issuer are established by the same entity that initiated the securitization;

(v) Cash equivalents for the purposes of the Permitted Assets; or

(vi) Securities received in lieu of a debt previously contracted with respect to the loans supporting the ABS.

Moreover, an eligible loan securitization may not hold any commodity forward contract or, except as permitted above, any securities (including ABS) or derivatives.

(g) Certain Asset-Backed Commercial Paper Conduits: An issuer of asset-backed commercial paper ("ABCP") whose assets are solely comprised of: (i) loans and other assets permissible for an exempt securitization (as described above); or (ii) ABS supported solely by such assets and that were acquired by the ABCP issuer as part of an initial issuance either directly from the ABS issuer or from an underwriter, provided that:

(i) The ADCP conduit issues only ABS comprised of a residual interest and securities with a legal maturity of no more than 397 days; and

(ii) A "regulated liquidity provider"[81] has a legally binding obligation to provide full and unconditional liquidity coverage with respect to the ABS issued by the conduit (other than any residual interest) in the event that funds are required to redeem maturing ABS.

(h) Qualifying Covered Bonds: An entity holding a pool of loans or other assets permissible for an exempt securitization (as described above) for the benefit of holders of "covered bonds."[82]

[81] "Regulated liquidity providers" include: (i) an FDIC-insured depository institution; (ii) a U.S. bank or savings and loan holding company (or any subsidiary thereof); (iii) a non-U.S. bank whose home country supervisor has adopted capital standards consistent with Basel III (or a subsidiary thereof); or (iv) the United States or a non-U.S. sovereign.

[82] For this purpose a "covered bond" means: (i) a debt obligation issued by a non-U.S. banking entity (or a subsidiary thereof), the payment of which is fully and unconditionally guaranteed by the entity holding the pool of loans or other assets; or (ii) a debt obligation of the entity holding the pool of loans or other assets, where such entity is a "wholly-owned or nearly wholly-owned subsidiary" (as discussed above) of a non-U.S. banking entity (or a subsidiary thereof) and such parent fully and unconditionally guarantees the payment of such obligation.

(i) SBICs and Public Welfare Investment Funds: An issuer that is: (i) an SBIC under the Small Business Investment Act of 1958 (or a company that has received a notice to proceed to qualify for such a license); (ii) "Designed primarily to promote the public welfare" under Section 24(Eleventh) of the National Bank Act; or (iii) a "qualified rehabilitation expenditure" with respect to a qualified rehabilitation building or certified historic structure under Section 47 of the Internal Revenue Code of 1986.

(j) Registered Funds: An issuer that is: (i) registered as an investment company ("RIC") or regulated as a business development company ("BDC") under the '40 Act;[83] or (ii) formed pursuant to a written plan to become a RIC or BDC and, in the meantime, operates in compliance with the leverage requirements of the '40 Act.[84]

(k) FDIC-Related Issuers: An issuer that is formed for the purpose of facilitating the disposal of assets acquired by the FDIC as receiver or conservator.

In addition to the foregoing, the Agencies may exempt other types of issuers in the future, if they make a public determination that such exclusions would be consistent with the purposes of the Volcker Rule.

3. What Are "Ownership Interests" of a Covered Fund?

As noted above, the Final Rule only prohibits acquiring or holding an *"ownership interest"* in a covered fund. The Final Rule defines an "ownership interest" to mean any equity or partnership interest or any other interest that exhibits any of the following features or characteristics on a current, future, or contingent basis:

(a) Has the right to participate in the selection or removal of the covered fund's general partner, managing member, directors, trustees, investment manager, investment adviser or commodity trading advisor (although not including the remedial rights of a creditor upon the occurrence of an event of default or acceleration event);

(b) Has the right to receive a share of the income, gains or profits of the covered fund;

(c) Has the right to receive the residual assets of the covered fund (not including creditor rights, as discussed above);

(d) Has the right to receive all or a portion of the excess spread (i.e., difference between the aggregate interest payments from the covered fund's underlying assets and the aggregate interest paid to holders of other outstanding interests);

(e) Provides that the interest amounts payable by the covered fund could (as per the terms) be reduced based on losses arising from the underlying assets of the covered fund;

(f) Receives income on a pass-through basis, or has a rate of return that is determined by reference to the performance of the underlying assets of the covered fund;[85] or

[83] Absent this exemption, such entities could have constituted covered funds, to the extent that they also fit the definition of a covered commodity pool.

[84] This includes an investment company which relies on Section 3(c)(1) or 3(c)(7) during its seeding period.

[85] "Ownership interests" would therefore include a lending arrangement with a covered fund in which the interest or other payments are calculated by reference to the profits of the fund. However, this definition would generally not include a loan that provides for a step-up in interest rate margin when a covered fund has fallen below or breached a NAV trigger or other negotiated covenant. This provision is also not

(g) Any synthetic right to have, receive or be allocated any of the foregoing rights.

A restricted profits interest (e.g., carried interest) earned by a banking entity in its role as investment adviser (or as provider of other services) to a covered fund will *not* be deemed to be an ownership interest as long as the following conditions are met:

(a) The sole purpose and effect of the interest is to allow the banking entity (or current or former employee thereof) to share in the profits of the covered fund as performance compensation for investment management, investment advisory, commodity trading advisory, or other services[86] performed for the covered fund, provided that the banking entity (or current or former employee) may be obligated to return profits previously received;[87]

(b) All such profit, once allocated, is: (i) distributed to the banking entity (or current or former employee thereof) promptly after being earned; or (ii) retained by the covered fund for the sole purpose of establishing a reserve amount to satisfy contractual obligations with respect to subsequent losses of the covered fund, and the reinvested profit does not share in the subsequent gains of the covered fund;[88]

(c) Any amounts invested in the covered fund in connection with obtaining the carried interest are, together with any other ownership interests in the fund held by the banking entity or its affiliates, within the limitations of the De Minimis Exception (or, if applicable, the Seeding Exception) and the Aggregate Limit (each discussed below);[89] and

(d) The interest held by the banking entity (or current or former employee thereof) is not transferable except to an affiliate (or employee of the banking entity or an affiliate), to immediate family members, or through the intestacy of the employee or former employee, or in connection with the sale of the business that gave rise to the carried interest to an unaffiliated party that provides services to the covered fund.[90]

4. When Is a Banking Entity Acting "as Principal"?

As noted above, the Final Rule's prohibition only applies where a banking entity acquires or holds an ownership interest in a covered fund *"as principal."* The Final Rule clarifies the scope of acting "as principal" by stating that the prohibition *does not* apply to a banking entity's acquisition or holding of an ownership interest in a covered fund, where the banking entity acts:

(a) Solely as agent, broker or custodian, so long as the activity is conducted for the account of, or on behalf of, a customer, and the banking entity and its affiliates do not have or retain beneficial ownership of the ownership interest;

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intended to encompass derivative transactions entered into in connection with typical prime brokerage activities of banking entities, provided such activities are not being used to evade the Volcker Rule.

[86] The Final Rule does not define the scope of such "other services," but the Agencies indicated that they would include acting, for example, as sub-advisor or placement agent.

[87] Unlike the Proposed Rule, the Final Rule would have permitted employees or former employees to retain carried interest after a change in employment status, so long as it was originally received for providing qualified services.

[88] This condition was modified from the Proposed Rule to allow for a "clawback": where the carried interest could be taken back and remain in the covered fund, until the occurrence of subsequent events (i.e., reaching specified rate of return levels).

[89] This condition was added to the Final Rule so as to allow the investment adviser or others to hold small amounts of ownership interest for the purpose of achieving the desired tax treatment for carried interest.

[90] While the Final Rule did lessen the restrictions on transferability, the rights to the carried interest still cannot be freely transferrable.

(b) Through a deferred compensation, stock-bonus, profit-sharing, or pension plan of the banking entity (or an affiliate thereof) that is established and administered in accordance with applicable U.S. or non-U.S. law, if the ownership interest is held or controlled directly or indirectly by the banking entity as trustee for the benefit of current or former employees of the banking entity (or affiliate);

(c) In the ordinary course of collecting a debt previously contracted in good faith, provided that the banking entity divests the ownership interest as soon as practicable (and within such period permitted by its primary federal regulator); or

(d) As trustee or in a similar fiduciary capacity for a customer that is not a covered fund, so long as the activity is conducted for the account of, or on behalf of, the customer, and the banking entity and its affiliates do not have or retain beneficial ownership of such ownership interest.

5. What Are the Exceptions to the Investment Prohibition?

Under the Final Rule, a banking entity, even when acting as principal, may acquire or hold an ownership interest in a covered fund, without regard to the prohibition, under the following circumstances:

(a) Funds "Organized and Offered" by the Banking Entity: A banking entity may invest in the ownership interests of any covered fund *"organized and offered"* by the banking entity or an affiliate, provided that certain per fund and aggregate limitations are satisfied. "Organizing and offering" a fund includes acting as "sponsor"[91] to the fund, but also includes other activities, such as serving as investment adviser (including sub-adviser), distributer, or broker to a covered fund. Accordingly, a banking entity may only use this exception to invest in covered funds with which it has such a relationship. Such investments are subject to the following:

(i) Per-Fund Limit: The aggregate investments[92] of the banking entity and its affiliates[93] cannot exceed 3 percent of the total number or value of that fund's outstanding ownership interests (or, in the case of a covered fund that issues ABS, three percent of the fund's fair market value,[94] unless a greater percentage is required under the risk-retention requirements of section 15G of the '34 Act[95]) (collectively, the "De Minimis Exception").[96]

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[91] The term "sponsor," as discussed in more detail below, means: (i) serving as a general partner, managing member, commodity pool operator or as a trustee with investment discretion; (ii) selecting or controlling a majority of the directors, trustees, or management; or (iii) sharing the same name (or a variation thereof) with a covered fund.

[92] Funds that are committed by the banking entity, but not yet called, do not count towards the per-fund limitation.

[93] For this purpose a covered fund sponsored by the banking entity will not be considered an affiliate, so long as it is organized and offered in accordance with the Final Rule (as discussed later herein). RICs, BDCs and non-U.S. public funds will not be considered an affiliate, provided the banking entity provides its services in accordance with applicable law and does not control 25 percent or more of the voting shares of such vehicle.

[94] This is due to the fact that such entities do not have a single class of security and thus, the valuation of the ownership interests cannot be made on a per interest or single class basis.

[95] A banking entity may rely on any of the options available to it in order to meet the requirements of section 15G, but for purposes of the Volcker Rule, the amount held by the banking entity may not exceed the amount required under the chosen option.

[96] The De Minimis Exception is intended to allow a banking entity to demonstrate "skin in the game" to third-party investors. While many commenters on the Proposed Rule argued that a three percent limit is too low to achieve this purpose, the Agencies declined to increase the limit. Compliance with the De Minimis Exception must be measured as of the last day of each calendar quarter, except in the case of ABS issuers, where it should be measured as of the date of establishment (as defined below) or such earlier date on which the transferred assets have been valued for purposes of transfer to the covered fund, and thereafter only when additional securities of the ABS issuer are priced for purposes of the sale of ownership interests to unaffiliated investors.

(1) In the case of a master-feeder structure, the foregoing limit only applies at the covered master fund — any investments made directly in the master will be aggregated with a pro rata share of any interest held through the covered feeder fund.

(2) Similarly, in the case of a fund of funds, any direct investment in a covered fund will be aggregated with a pro rata share of any interest held through a covered fund of funds.

Notwithstanding the foregoing, during the first year after a covered fund is "established,"[97] the banking entity and its affiliates may exceed the 3-percent limitation and own up to 100 percent of the covered fund's ownership interests, so long as it actively seeks outside investors during this period (the "Seeding Exception").[98] The Board may grant an extension of the Seeding Exception (not to exceed two years) requested by a banking entity, if such extension would be consistent with safety and soundness and not detrimental to the public interest.[99]

(ii) Aggregate Limit: The aggregate value of all covered fund ownership interests held by the banking entity and its subsidiaries cannot exceed 3 percent of the tier 1 capital of the banking entity (the "Aggregate Limit").[100] For this calculation, the aggregate value of such ownership interests is the sum of all amounts paid or contributed (including by an entity or employee in connection with a carried interest) on a historical cost basis.[101] Moreover, the Final Rule requires that the banking entity deduct from its tier 1 capital (for both the foregoing calculation and for measuring compliance with applicable U.S. regulatory capital requirements) the greater of: (i) the foregoing historical cost *plus* earnings; or (ii) the fair market value of such ownership interests, if the profits or losses of the investments were reflected on the entity's financial statements.[102]

The Proposed Rule also contained a provision intended to curb potential evasion of the foregoing per-fund and aggregate limitation through investments made outside, but parallel with, a covered fund. Specifically, the Proposed Rule provided that, to the extent that a banking entity is contractually obligated to invest in, or is found to be acting in concert through knowing participation in a joint activity or parallel action toward a common goal of investing in, one or more investments with a covered fund that is organized and offered by the

[97] The Final Rule clarified that, for this purpose, a covered fund is deemed to be established on the date on which it begins to make investments. In order to account for the unique circumstances and manner in which securitizations are established, for a covered fund that is an issuer of ABS, the date of establishment is the date on which the assets are initially transferred into the issuer.

[98] While many commenters on the Proposed Rule argued that the one year period is often insufficient to build up a track record necessary to attract outside investors, the Agencies declined to increase the timeframe. However, they did reference the possibility of obtaining an extension from the Board in such cases.

[99] A banking entity must make any request for such an extension at least 90 days prior to the normal expiration of the Seeding Exception. In reviewing such a request, the Board may consider all relevant factors and facts, including: (i) whether the investment exposes the banking entity to high-risk assets or strategies; (ii) the contractual terms of the investment; (iii) the expected length of additional time necessary to attract sufficient outside investors; (iv) the banking entity's total exposure to the fund and the risks of maintaining, or disposing of, the investment to the entity or U.S. financial stability; (v) the cost of divesting the investment within the normal timeframe; (vi) any material conflicts of interest between the banking entity and any third-party to which it owes a duty that would result from approving or denying the request; (vii) the entity's prior efforts to reduce its ownership percentage; and (viii) market conditions.

[100] Measured as of the last day of each calendar quarter. If a banking entity is not required to calculate and report tier 1 capital, or is it directly or indirectly controlled by an entity that is so required, then tier 1 capital for this purpose is the total shareholder's equity for the entity's top-tier affiliate. While the Aggregate Limit must be calculated on a quarter-end basis, the Agencies expect banking entities to monitor their investments regularly and remain in compliance throughout the quarter.

[101] By requiring the use of historical cost, the Final Rule prevents a banking entity from increasing its exposure to covered funds in the event any particular covered fund investment declines in value.

[102] Therefore, profits resulting from investments in covered funds will not inflate the capital of the banking entity for U.S. regulatory compliance purposes. The Final Rule does not require a non-U.S. banking entity that makes a covered fund investment in the United States to deduct the aggregate value of the investment from the entity's tier 1 capital calculated under applicable home country standards.

banking entity (whether or not pursuant to an express agreement), such investment must be included in the calculation of a banking entity's per-fund limitation applicable to that fund. The Final Rule omitted this provision, but the Agencies indicated that a banking entity should not make any co-investment with a sponsored covered fund in a privately negotiated investment unless the value of such co-investment is less than three percent of the value of the total amount co-invested by other investors in such investment.[103]

(b) Underwriting and Market Making: The Final Rule added a specific provision (similar to that already contained in the proprietary trading section of the Proposed Rule) allowing banking entities to hold ownership interests in covered funds when the entity is engaged in underwriting and market making-related activities of ownership interests in such funds, so long as:

(i) The banking entity conducts the activities in accordance with the Final Rule's prohibition on proprietary trading;

(ii) Any covered fund ownership interests held by the banking entity and its affiliates pursuant to this exception are: (i) deducted from tier 1 capital (as discussed above); and (ii) within the Aggregate Limit (when aggregated with any other investments that are subject to the Aggregate Limit); and

(iii) If the banking entity (or an affiliate thereof): (i) acts as a sponsor, investment adviser or commodity trading advisor to a particular covered fund; (ii) otherwise acquires and retains an ownership interest in the fund in relation to organizing and offering the fund; (iii) acquires and retains an ownership interest in the fund and is either a "securitizer,"[104] or is acquiring and retaining an ownership interest in the fund in compliance with section 15G of the '34 Act; or (iv) directly or indirectly guaranties or insures the obligations or performance of the fund or of any covered fund in which the fund invests,[105] then in each such case the value of any ownership interests held by the banking entity and its affiliates pursuant to this exception in that fund are permissible under the De Minimis Exception (or, if applicable, the Seeding Exception) and the Aggregate Limit (when aggregated with any other investments that are also subject to such limits).

(c) Risk-Mitigating Hedging: The Final Rule permits a banking entity to hold an ownership interest in a covered fund in order to "demonstrably reduce" or "significantly mitigate" the "specific, identifiable" risks to the banking entity from a compensation arrangement with an employee (or an employee of an affiliate) that directly provides investment advisory or other services to that fund.[106] In other words, a banking entity may invest in a covered fund to hedge the risk

[103] Further, if the co-investment is made through a co-investment vehicle that is itself a covered fund (a "co-investment fund"), the sum of the banking entity's ownership interests in the co-investment fund and the related covered fund should not exceed three percent of the sum of the total ownership interests in the co-investment fund and the covered fund.

[104] As that term is used in section 15G(a)(3) of the '34 Act.

[105] This restriction does not prohibit a banking entity from entering into or providing liquidity facilities or letters of credit for covered funds; however, it would apply to arrangements such as a put of the ownership interest in the covered fund to the banking entity.

[106] The Final Rule appears to be more stringent, in this regard, than the Proposed Rule, which merely required that the investment be "designed to reduce the specific risks" associated with the compensation arrangement. More importantly, while the Proposed Rule contained an additional exemption allowing a banking entity to invest in a covered fund in order to hedge risk arising when the banking entity serves as an intermediary for a customer to facilitate exposure by such customer to the fund, the Agencies omitted this exemption from the Final Rule. Currently, such a practice typically occurs when bank customers choose to obtain exposure to a covered fund via a derivative issued to them by a bank (this is done for a variety of reasons, including obtaining leverage). In turn, the banking entity invests in the fund to hedge its exposure to the customer. However, since the Agencies omitted the proposed exemption designed to permit such hedging from the Final Rule, such investors will need to consider alternative arrangements.

associated with employee compensation that is tied to that fund's performance.[107] Notwithstanding the foregoing, a banking entity may not enter into any hedging investment that, at its inception, gives rise to any significant new or additional risk that is not, itself, hedged contemporaneously.

In order to avail itself of this exemption, a banking entity must have internal written policies and controls to ensure compliance with the Final Rule's requirements associated with such hedging activity.

(d) Investments Made "Solely Outside the United States": Certain eligible non-U.S. banking entities are permitted to hold ownership interests in certain eligible covered funds, so long as such activity occurs "solely outside the United States."

(i) Eligible Banking Entities: In order for a banking entity to use this exemption, the following criteria must be satisfied:

(1) The banking entity is not organized, or directly or indirectly controlled by a banking entity organized, in a U.S. jurisdiction (including any U.S. territory or commonwealth).[108]

(2) If the entity is a "foreign banking organization" under the Board's Regulation K, it qualifies for the exemption.[109]

(3) If the entity is *not* a "foreign banking organization" under the Board's Regulation K, it must satisfy at least two of the following:

a. Its total assets held outside the United States exceed those held in the United States;

b. Its total revenues from its non-U.S. business exceed those from its U.S. business;

c. Its total net income from its non-U.S. business exceed that from its U.S. business.

(ii) Eligible Covered Funds: In order for an eligible non-U.S. banking entity to invest in a covered fund under this exemption, the fund must not sell its ownership interests in any offering that targets "U.S. persons" (as defined under the SEC's Regulation S).[110] (It is

[107] The compensation arrangement hedged under this exemption must relate solely to the covered fund in which the banking entity (or any affiliate thereof) has acquired an ownership interest, such that any losses on the ownership interest would be offset by corresponding decreases in the amounts payable under the compensation arrangement.

[108] Thus, non-U.S. subsidiaries or non-U.S. offices of a U.S. banking entity may not take advantage of this exemption. The disparate treatment of U.S. and non-U.S. banking entities is this regard is basically unchanged from the Proposed Rule. While numerous commenters on the Proposed Rule complained that it would impose a competitive disadvantage on U.S. banking entities, the Agencies indicated that, in addition to there being potential policy reasons to support such disparate treatment, they were bound by the express statutory language of the Volcker Rule.

[109] Under Regulation K, a "foreign banking organization" is a foreign bank that operates a branch office, agency office, commercial lending company, bank subsidiary or Edge Act corporation in the United States, or any subsidiary of such an institution. To constitute a "qualifying foreign banking organization," it must satisfy two tests (unless otherwise permitted by the Board). First, it must satisfy at least two of the following: (i) its banking assets held outside the United States exceed its total worldwide nonbanking assets; (ii) its revenues derived from the business of banking outside the United States exceed its total revenues derived from its worldwide nonbanking business; or (iii) its net income derived from the business of banking outside the United States exceeds its total net income derived from its worldwide nonbanking businesses. Second, it must satisfy at least two of the following: (i) its banking assets held outside the United States exceed its banking assets held in the United States; (ii) its revenues derived from the business of banking outside the United States exceed its revenues derived from the business of banking in the United States; or (iii) its net income derived from the business of banking outside the United States exceeds its net income derived from the business of banking in the United States.

[110] This is a more forgiving standard than that of the Proposed Rule, which appeared to turn solely on whether any of the fund's ownership interest were actually owned by any U.S. resident. Instead, in promulgating the Final Rule, the Agencies indicated that (absent circumstances otherwise indicating a nexus with U.S. persons), the sponsor of a foreign fund would not be viewed as targeting U.S. persons if it: (i) conducts an offering directed to non-U.S. residents; (ii) includes in the offering materials a prominent disclaimer that the securities are not being offered in the United States or to U.S. residents; and (iii) employs reasonable procedures to limit access to the materials to non-U.S. residents.

important to note that the Final Rule does not appear to predicate eligibility on where the covered fund invests, where its investment manager is located, or even in what jurisdiction the fund is organized.)

Master-Feeder Structures: A covered feeder fund that satisfies the foregoing will, nonetheless, not be eligible if the covered master fund it which it invests does not also satisfy the foregoing.

(iii) Eligible Activity: In order for activity to occur "solely outside the United States" the following criteria must be satisfied:

(1) The eligible banking entity (or office thereof) acting as principal (and that makes the decision to engage in the activity, if different) is not organized or located in the United States.[111]

(2) No relevant personnel of the entity responsible for the decision to engage in the activity is located in the United States (excluding "back office" personnel[112]);

(3) The activity is not accounted for as principal, directly or indirectly, on a consolidated basis by a branch or affiliate organized or located in the United States; and

(4) No financing is provided, directly or indirectly, by a branch or affiliate organized or located in the United States.

(e) Insurance Company Investments: The Final Rule added a specific provision (similar to that already contained in the proprietary trading section of the Proposed Rule) allowing banking entities that are regulated insurance companies (and their affiliates) to hold ownership interests in covered funds if the investment:

(i) Is held solely for the general account of the insurance company or for one or more separate accounts established by it; and

(ii) Complies with the insurance law in which the insurance company is domiciled (and the appropriate federal banking agencies have not determined that such law is insufficient to protect the banking entity's safety and soundness or the financial stability of the United States).

B. 'Prohibition'[113] on Sponsorship of Funds

1. What Does It Mean to "Sponsor" a Fund?

As noted above, a banking entity may no longer "sponsor" a covered fund, unless it abides by a series of new requirements on its relationship with such fund (or such sponsorship falls within the exemption for non-U.S. activity explained below). The Final Rule defines the term "sponsor" to mean:

[111] For this purpose, any U.S. office of a non-U.S. bank (or any subsidiary of such office) is located in the United States, but the bank itself is not.

[112] The Agencies explained that this permits U.S. employees to provide administrative services or similar support functions (such as clearing and settlement, maintaining and preserving records, furnishing statistical and research data, or providing clerical support).

[113] While the Volcker Rule purports to "prohibit" a banking entity from "sponsoring" a covered fund, subject to certain exceptions, in a practical sense, it instead imposes a series of new requirements on a banking entity's sponsorship activities.

(a) Serving as a general partner, managing member, trustee (excluding trustees that do not exercise investment discretion[114]), or commodity pool operator of a covered fund;

(b) Selecting or controlling, in any manner, a majority of the directors, trustees or management of a covered fund; or

(c) Sharing with a covered fund, for corporate, marketing, promotional or other purpose, the same name or a variation of the same name.[115]

However, sponsoring does not include other activities that may be part of organizing and offering a covered fund, such as merely acting as an investment adviser, sub-adviser, distributor or broker to the fund.

2. Under What Circumstances May a Banking Entity Sponsor a Covered Fund?

A banking entity may sponsor a covered fund[116] in connection with "organizing and offering" such fund (as discussed above), provided that the following requirements are satisfied:

(a) The banking entity must provide bona fide trust, fiduciary, investment advisory or commodity trading advisory services.[117]

The covered fund must be offered only to persons that are customers of such services. However, such customer relationship need not be pre-existing or involve more than the relevant fund investment; the banking entity must merely demonstrate (through written documentation) that the fund is organized and offered for the purpose of providing one or more of the foregoing bona fide services to its customers (or those of an affiliate) and not for the purpose of evading the Volcker Rule.

(b) No director or employee of the banking entity may hold an ownership interest in the covered fund, except for a director or employee who is directly engaged in providing investment advisory, commodity trading advisory or other services[118] to such fund.[119] (However, directors or employees who received a permitted ownership interest may retain that interest after no longer serving in the same capacity.)

However, any ownership interest purchased by a director or employee pursuant to a loan, guarantee or extension of credit by the banking entity will be attributed to the banking entity itself.

(c) The banking entity must not hold an ownership interest in the covered fund (including any interest held by an employee or director that is attributed to the entity as explained above),

[114] Including a trustee that is subject to the direction of an unaffiliated fiduciary pursuant to section 403(a)(1) of the Employee's Retirement Income Security Act, or a trustee that is subject to fiduciary standards imposed under foreign law that are substantially equivalent to the foregoing.

[115] However, as indicated below, such name sharing is elsewhere prohibited by the Final Rule.

[116] Including a covered fund that is an ABS issuer.

[117] However, this requirement does not apply where the sponsored covered fund is an ABS issuer.

[118] The Agencies explained that this exemption also applies to directors or employees who provide "services that enable the provision or investment advice or investment management, such as oversight and risk management, deal orientation, due diligence, administrative or other support services."

[119] The authority for such employees to invest in the fund is based on a similar "skin in the game" concept as the De Minimis Exception (i.e., it aligns the manager or adviser's incentives with those of the banking entity's customers).

except as consistent with the De Minimis Exception (or, if applicable, Seeding Exception) or Aggregate Limit.

(d) The covered fund must not share the same name, or a variation of the same name, as the banking entity (or any affiliate thereof) for any purposes,[120] nor can it use the word "bank" in its name.

(e) The banking entity (and its affiliates) must not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered find invests.[121]

(f) The banking entity must provide written disclosure to prospective and actual investors that clearly and conspicuously: (i) indicates that all investors should read the fund offering documents before investing; (ii) describes the role of the banking entity and its affiliates and employees in sponsoring or providing any services to the covered fund; and (iii) contains the following representations:

(i) "Any losses in [such covered fund] will be borne solely by investors in [the covered fund] and not by [the banking entity] or its affiliates; therefore, [the banking entity's] losses in [such covered fund] will be limited to losses attributable to the ownership interests in the covered fund held by [the banking entity] and any affiliate in its capacity as investor in the [covered fund] or as beneficiary of a restricted profit interest held by [the banking entity] or any affiliate"; and

(ii) "Ownership interests in the covered fund are not insured by the FDIC, and are not deposits, obligations of, or endorsed or guaranteed in any way, by any banking entity" (unless that happens to be the case).[122]

(g) The banking entity must take any additional steps required by the federal regulators to ensure that it is, in fact, not liable for any fund losses.

(h) When engaging in any transactions with the covered fund, the banking entity must comply with certain restrictions (as discussed below).[123]

3. When Is a Non-U.S. Banking Entity Exempt from the Foregoing Requirements?

The same exemption for activity occurring "solely outside the United States" discussed above in the context of acquiring covered fund ownership interests applies to sponsorship of covered funds. Thus, an "eligible banking entity" (as discussed above) may sponsor an "eligible covered fund," provided the sponsorship is deemed to occur "solely outside the United States" (each as discussed above).

[120] While numerous commenters on the Proposed Rule argued that the name-sharing prohibition should not apply with regard to banking entities that are an insured depository institution, the Agencies declined to provide such relief (suggesting that they were bound by the express statutory language of the Volcker Rule). Accordingly, the name of a covered fund that is sponsored by a banking entity must be dissimilar to that entity and *all* of its affiliates, including any serving as the fund's general partner or managing member.

[121] However, the Agencies indicated that a banking entity's issuance of a borrower default indemnification to a lending client in connection with a securities lending transaction involving a sponsored covered fund is not prohibited.

[122] Many banking entities that sponsor funds already include similar disclosure in the funds' offering documents. However, like the Proposed rule, the Final Rule appears to require that these two disclosures be given verbatim (with the insertion of the appropriate names).

[123] The Final Rule explicitly clarifies that the foregoing exemption also applies to sponsoring an ABS issuer, subject to the same rules (except that in such a case the requirements relating to the offering of bona fide trust, fiduciary, investment advisory, or commodity trading advisory services would not apply).

For the purpose of determining whether the activity satisfies the "solely outside the United States" requirement, the Agencies have indicated that the U.S. personnel of a non-U.S. banking entity may provide investment advice and recommendations to the manager or general partner of a covered fund so long as that investment advisory activity in the United States does not result in the U.S. personnel participating in the control of the covered fund or offering or selling an ownership interest to a resident of the United States.

4. What Rules Apply to Transactions Between a Banking Entity and Any Fund It Organizes and Offers?

   The Final Rule imposes the following new rules on any transactions between a banking entity (or any of its affiliates) and any covered fund for which such entity serves as sponsor, investment manager, investment adviser or commodity trading adviser, or which it otherwise organizes and offers[124]:

   (a) Market Terms Requirement: A banking entity (and its affiliates) may not provide any services or sell any assets to a such a covered fund, except as consistent with Section 23B of the Federal Reserve Act ("Section 23B").[125] As applied by the Final Rule, Section 23B requires that such transactions be conducted on terms, and under circumstances, that are at least as favorable to the banking entity as those prevailing at the time for comparable transactions involving unaffiliated companies.

       If no relevant market terms exist, then the transaction must be on terms, and under circumstances, that in good faith would be offered by the banking entity to nonaffiliates.

   (b) Prohibited Transactions: Except as provided below, a banking entity may not enter into any transaction with such a covered fund, if the transaction would constitute a "covered transaction" as defined in Section 23A of the Federal Reserve Act ("Section 23A").[126] In this context, "covered transactions" under Section 23A would include:

       (i) Loans and other extensions of credit to the fund (including any purchase of assets subject to agreement to repurchase);

       (ii) A purchase of, or an investment in, securities issued by the fund (except that acquisition or retention of ownership securities issues by the fund in a manner that is otherwise permitted by the Final Rule would not be prohibited);

       (iii) A purchase of assets from the fund (other than such purchases of real and personal property as may be specifically exempted by the Board by order or regulation);

       (iv) The issuance of a guarantee, acceptance or letter of credit (including an endorsement or standby letter of credit) on behalf of the fund; and

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[124] This requirement applies even where the services provided to the covered fund were not themselves subject to the Final Rule's sponsorship prohibition (i.e., where the relationship does not constitute sponsoring or is otherwise exempt from the prohibition).

[125] By its terms Section 23B only applies to transactions between a banking entity that is a member of the Federal Reserve System ("member bank") and any of its affiliates. However, for this purpose, the Volcker Rule applies Section 23B as if: (i) the banking entity transacting with the covered fund were a member bank; and (ii) the fund were an affiliate of such banking entity.

[126] Like Section 23B, Section 23A only applies to transactions between a member bank and any of its affiliates. However, the Volcker Rule applies Section 23A on the same basis as Section 23B (as discussed above). Moreover, while Section 23A normally merely imposes certain qualitative requirements and quantitative limits on "covered transactions," the Volcker Rule prohibits them outright. Because the Volcker Rule, expands the scope of entities to which Section 23A applies and replaces its requirements/limits with a prohibition, the Volcker Rule's application of Section 23A has been commonly referred to as "Super 23A."

(v) A securities lending, securities borrowing or derivative transaction with the fund, to the extent it caused the banking entity to have credit exposure to the fund.[127]

(c) Prime Brokerage Transactions: The foregoing prohibition of covered transactions does not apply to "prime brokerage transactions" with a covered fund in which a covered fund sponsored, managed or advised by the banking entity (or an affiliate thereof) invests (however, such transactions would remain subject to the Section 23B requirements discussed above).[128]

(i) Scope: Under the Final Rule, a "prime brokerage transaction" is defined as "any transaction that would be a covered transaction [under Section 23A], that is provided in connection with custody, clearance and settlement, securities borrowing or lending services, trade execution, financing, or data, operational, and administrative support."

(ii) Prerequisites: This exemption is available only so long as: (i) the chief executive officer (or equivalent officer) of the banking entity[129] certifies annually that the banking entity does not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such fund invests; and (ii) the Board has not determined that the relevant transaction is inconsistent with the banking entity's safety and soundness.

C. Other Prohibited Activities

Notwithstanding any of the foregoing, a banking entity may not engage in any activity or transaction with a covered fund, otherwise permitted under the Final Rule, if such activity or transaction would:

1. Involve a "material conflict of interest" between the banking entity and its clients, customers or counterparties;

   Unless, prior to engaging in such activity or transaction, the banking entity: (i) gives the other party clear and effective disclosure of the conflict and the opportunity to negate or substantially mitigate its impact; or (ii) the banking entity has information barriers that are reasonably designed to prevent a materially adverse effect on the other party (except where the banking entity knows, or should reasonably know, that the barriers are unlikely to prevent a particular materially adverse effect);

2. Materially expose the banking entity to an asset, group of assets or trading strategy that would significantly increase the likelihood of: (i) substantial loss by the banking entity; or (ii) a threat to the financial stability of the United States; or

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[127] Section 23A and its implementing regulation contain several exemptions that excuse certain covered transactions from some of the requirements of Section 23A. While numerous commenters on the Proposed Rule argued that such exemptions should be incorporated into Super 23A, the Agencies disagreed because the statutory language of the Volcker Rule makes no reference to such exemptions when it incorporates the "covered transaction" definition from Section 23A. However, on another issue, the Agencies' strict reading of the Volcker Rule's incorporation of Section 23A worked to the benefit of banking entities. The Agencies noted that the statutory language only prohibits covered transactions *with a covered fund*. Thus, while Section 23A and its implementing regulation treat certain transactions between a bank an unaffiliated third party as covered transactions — where an affiliate is a known beneficiary of the transaction — Super 23A does not prohibit such transactions. Accordingly, for example, a banking entity is permitted to extend credit to a customer where such lending is secured by shares of a covered fund that the entity organizes and offers (including pursuant to a margin account), even though such a transaction would ordinarily be considered a covered transaction under Section 23A.

[128] It is important to note that this exception for prime brokerage transaction does *not* apply to transactions with the covered fund sponsored, managed or advised by the banking entity, *only* to transactions with a "second-tier" covered fund (i.e., one in which the first fund invests). However, for reasons apart from the Volcker Rule, many banking entities already do not serve as prime broker for the funds they organized and offer.

[129] In the case of the U.S. operations of a non-U.S. banking entity, the senior officer of its U.S. operations may provide the required attestation.

3. Pose a threat to the safety and soundness of the banking entity or the financial stability of the United States.[130]

D. Timing

1. Conformance Date: Banking entities had until July 21, 2015 to conform their activities to the Final Rule.[131] This deadline represented a one-year extension of the Volcker Rule's conformance period, which the Board granted simultaneously with the issuance of the Final Rule.[132]

2. Conformance Period Obligations: Until July 21, 2015, each banking entity was expected to engage in "good-faith efforts" to conform its activities and investments to the requirements of the Volcker Rule and the Final Rule, including developing and implementing the compliance program requirements of the Final Rule. The Board has explained that such good faith efforts should have included "evaluating the extent to which the banking entity is engaged in activities and investments that are covered by [the Volcker Rule] and the [Final Rule], as well as developing and implementing a conformance plan that is appropriately specific about how the banking entity will fully conform all of its covered activities and investments by the end of the conformance period."

3. Potential Extensions: Under the Volcker Rule, the Board is empowered to grant a banking entity up to three one-year extensions. As indicated above, the Board has now used one of those potential extensions to grant the entire industry a one-year delay of the conformance date. Thus, a banking entity could potentially seek up to two additional one-year extensions.[133] Additionally, the Board may *further* extend the conformance date, up to an additional five years, for the acquisition or retention of an ownership interest in any "illiquid fund" if: (i) such investment was made or contractually obligated by May 1, 2010; and (ii) the banking does not have the contractual right to terminate the investment or commitment.[134]

4. However, the Board cautioned that a banking entity "should not expand activities or make investments during the conformance period with an expectation that additional time to conform those activities or investments will be granted."

V. Permanent Capital Vehicles: Options for Creating Permanent Capital Vehicles for Existing Fund Managers

A. Benefits of Permanent Capital

1. Eliminates redemption risks

2. Eliminates limited fund life concerns

3. Allows longer-term strategies

[130] These are necessarily subjective analyses that a banking entity will have to undertake, but that will ultimately be judged (often with hindsight) by its primary federal regulator.

[131] Notwithstanding the foregoing, a company that was not a banking entity on July 21, 2010, must have brought its activities into conformance before the later of (i) July 21, 2015 or (ii) two years after the date on which the company becomes a banking entity.

[132] In doing so, the Board indicated that it will continue to monitor developments to determine whether additional extensions of the conformance period would be in the public interest and consistent with the statute.

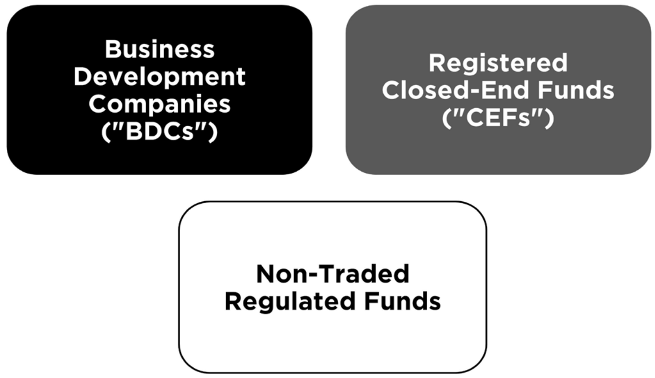
[133] Any extension request must be submitted in writing at least 180 days in advance and must contain a detailed explanation of the banking entity's plan for divesting or conforming the activity, as well as an analysis of numerous factors required by the Board.

[134] In other words, the conformance date for investments in "illiquid funds" could be extended to as late as July 21, 2022. An "illiquid fund" is a covered fund that, as of May 1, 2010, was principally invested in "illiquid assets" (as defined by the Board), or was invested in, and contractually committed to principally invest in, illiquid assets; and makes all investments pursuant to, and consistent with, an investment strategy to principally invest in illiquid assets.

4. Provides access to follow-on public debt and equity offerings

5. Provides similar management and incentive fee structures to many private funds

B. Regulated Funds That Utilize Permanent Capital



C. Permanent Capital Investment Strategies

1. Key focus is typically on income-producing portfolios that can generate attractive dividend yields for investors.

(a) Credit strategies, particularly in the high-yield space

(b) Cash flow focused strategies that target control investments with attractive cash flow potential

(c) Real estate strategies that focus on commercial or residential mortgages or rental income properties

(d) Capital gains focused strategies that target short term (i.e., less than one year) realized capital gains

(e) Other strategies that target high ROI levels with an income component

D. Business Development Companies

1. What Are BDCs?

(a) Special type of closed-end fund that is *regulated* rather than *registered* under the '40 Act

(b) Hybrid between a public finance company and a registered investment company from a regulatory perspective

(c) In exchange for greater regulatory flexibility, a BDC must invest 70 percent of its assets in "good" BDC assets

(i) Typically U.S.-based nonpublic operating companies

(ii) Extends to listed companies with market capitalizations of less than $250 million

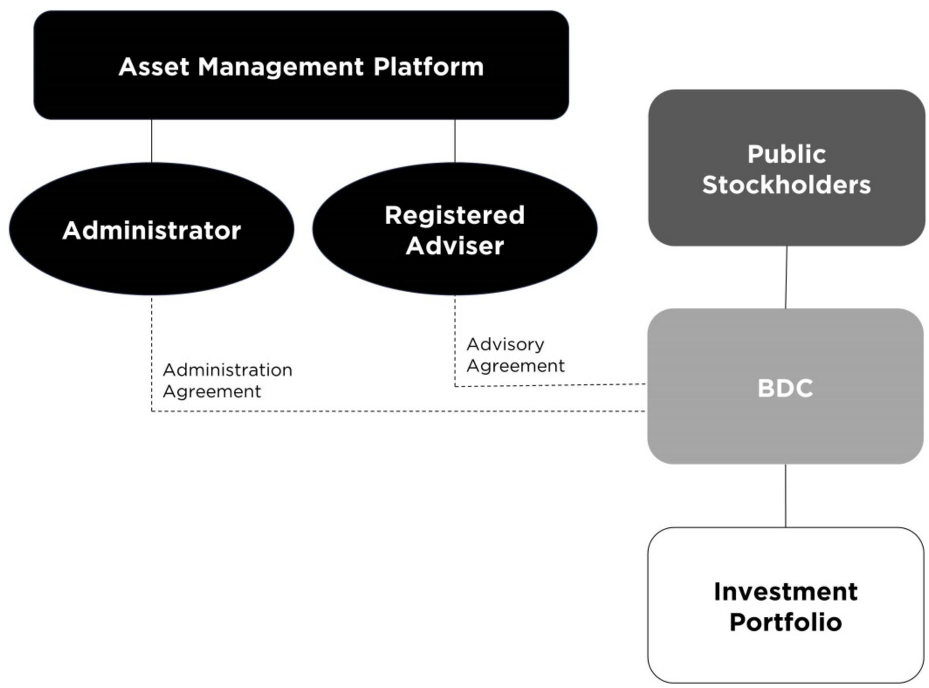
(iii) Excludes "investment companies," including most private funds

(d) Must have at least a 200-percent asset coverage ratio (total assets/total debt) at the time of any new borrowings

(e) File annual, quarterly and current reports under the '34 Act on the same basis and in the same manner as traditional operating companies

(f) If not publicly traded, BDC public offerings are subject to "blue sky" registration in each state where an offering will be made

2. Typical BDC Structure



3. Benefits of the BDC Model

(a) Access to public capital markets

(b) Securities can be listed on national securities exchanges

(c) Flow-through tax treatment as a "regulated investment company" ("RIC")

(d) External model permits management fee and incentive fee structures similar to traditional private fund structures

(e) Increased transparency from publicly available quarterly financial information

(f) Certain offshore and tax-exempt investors can invest directly, rather than through offshore blockers

4. Other Considerations

(a) Federal Tax Compliance

(i) BDCs need to comply with applicable diversification and source of income requirements as RICs

(ii) Income must generally be distributed as earned — in short, it is often difficult to retain earnings to grow

(b) Leverage Restrictions

(i) BDCs have limits on their use of leverage, and must maintain a 200-percent asset coverage ratio

(ii) Those restrictions limit the ability to invest in lower-yielding investments where significant leverage would be required

(c) Restrictions on Transactions with Affiliates

(i) BDCs have specific restrictions on acquiring or selling assets to affiliates, and on participating in co-investment transactions with affiliates

(ii) Asset manager may need to obtain SEC exemptive relief to permit even pro rata investment allocations involving a BDC

(d) Public Reporting Requirements

(i) Subject to periodic reporting requirements with the SEC that mirror those applicable to publicly-traded operating companies

(ii) BDCs must comply with additional compliance requirements under the '40 Act, including with respect to:

(1) Custody of assets

(2) Maintenance of records

(3) Appointment of a chief compliance officer

(4) Restrictions on holding securities of asset managers, broker-dealers and other investment companies

E. Registered Closed-End Funds

1. What Are Registered Closed-End Funds ("CEFs")?

(a) CEF that *registers* under the '40 Act.

(b) Unlike BDCs, CEFs generally have no '40 Act limitations on nature and type of investments.

(c) As a result of greater investment flexibility, CEFs are often used by asset managers in lieu of a BDC structure to allow offshore or other investments that would be considered "bad" BDC assets.

(d) A CEF must have at least a 300-percent asset coverage ratio (total assets/total debt) at the time of any new borrowings.

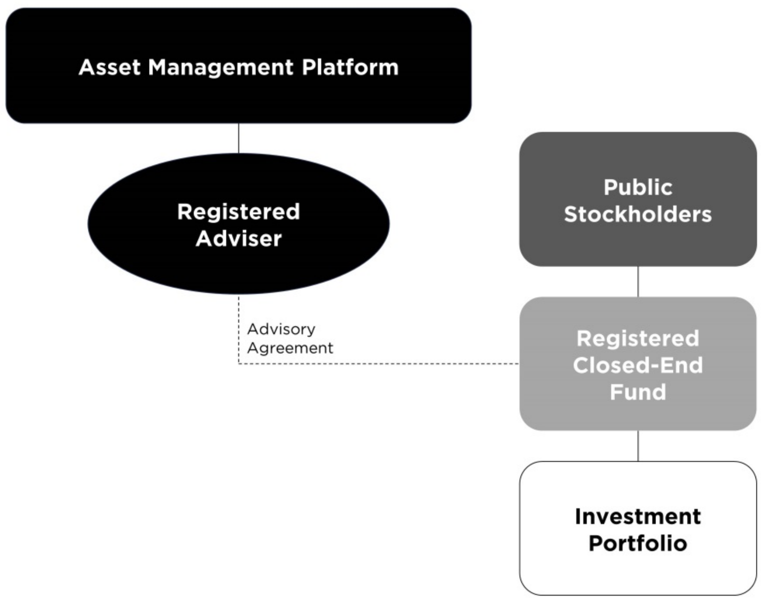
(e) A CEF must have at least a 200-percent asset coverage ratio (total assets/(preferred stock + total debt)) at the time of issuing any new preferred stock.

(f) Incentive fees on realized capital gains are generally prohibited.

(g) Public reporting requirements include an annual and semi-annual report, along with a publicly-filed schedule of investments on off quarters.

(h) Public offerings by non-traded CEFs are subject only to notice filings under state "blue sky" laws.

2. Typical Registered Closed-End Fund Structure



3. BDCs vs. Registered Closed-End Funds

(a) Business Development Companies

(i) Allow greater leverage than typical registered closed-end funds: Limit of "one-to-one" debt to equity vs. "one-to-two" debt to equity

(ii) Permit use of capital gains incentive fees for asset managers

(iii) Provide slightly greater flexibility for transactions with remote affiliates

(iv) Greater leverage permits investment in more liquid credit instruments, which lower unleveraged returns

(b) Registered Closed-End Funds

(i) Allow hedge funds or funds of funds to have broader investor bases, without relying on 3(c)(1) or 3(c)(7)

(ii) Permit an asset manager to target novel or unique asset classes that would be ineligible in a BDC structure

(iii) Frequently target investments in existing leveraged products, or where significant leverage at the fund level is unnecessary

(iv) Reduce state "blue sky" compliance for non-traded vehicle structures compared to BDCs

(v) Require a reduced public reporting burden compared to a BDC structure

F. Non-Traded Regulated Funds

1. What Are Non-Traded Regulated Funds?

(a) Structured as a BDC or registered closed-end fund

(b) Shares are *not* listed on an exchange

(c) Shares sold through continuous offerings up to preset maximum amount

(d) Liquidity offering through periodic repurchase offers

(e) Typically have fixed five- to seven-year period before exchange listing or traditional IPO

(f) Becomes public reporting company upon first closing

2. Non-Traded Regulated Fund Sponsors

(a) Non-traded regulated funds are generally structured as a combination of an investment adviser or sub-adviser and a distributor.

(b) For example:

(i) GSO/Blackstone serves as the sub-adviser for Franklin Square's funds, while FS2 Capital Partners is the dealer manager.

(ii) KKR Asset Management is the investment sub-adviser for Corporate Capital Trust, while CNL Fund Advisors serves as the dealer manager.

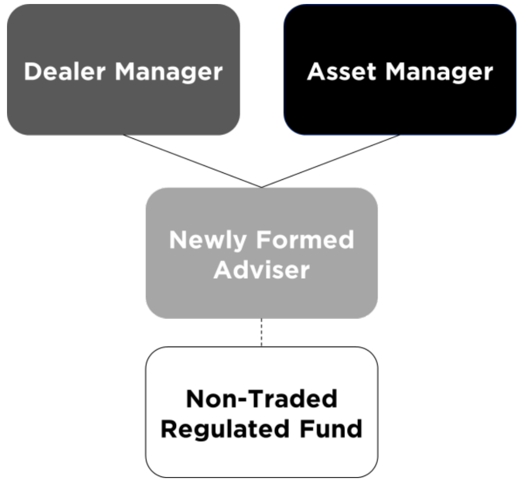
(iii) Apollo Global Management serves as investment sub-adviser for CION Investment Corp., while ICON Securities serves as the dealer manager.

(iv) SIC Advisors (investment personnel of Medley) is the investment adviser to Sierra Income Corporation, while SC Distributors is the dealer manager.

(c) Business Development Corporation of America is the only non-traded BDC that does not utilize a third-party investment adviser or sub-advise.

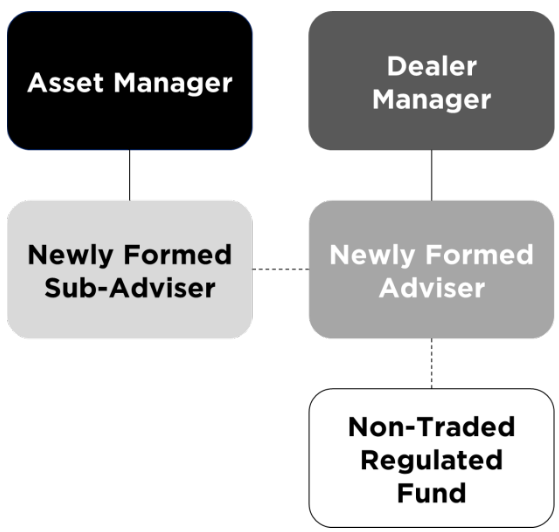
3. Typical Fund Sponsor Structures

(a) Jointly-Controlled Adviser



A newly formed regulated fund adviser is jointly owned by the co-sponsoring asset manager and dealer manager, who use the operating agreement of the new adviser to split economics for the joint venture.

(b) Adviser/Sub-Adviser Model



A newly formed adviser controlled by the dealer-manager enters into an advisory agreement with the regulated fund, as well as a sub-advisory agreement with a newly formed sub-adviser controlled by the asset manager, with the economics split between the advisory and sub-advisory agreements.

4. Current Non-Traded Regulated Funds

(a) These non-traded regulated funds are making continuous offerings and had raised in excess of $11.9 billion as of Dec. 31, 2014:

(i) Business Development Corporation of America — $1.6 billion

(ii) Business Development Corporation of America II — $200 million

Affiliated with AR Capital

(iii) CION Investment Corporation — $476 million

Affiliated with ICON Capital Corp. and Apollo Global Management

(iv) Corporate Capital Trust — $2.1 billion

Affiliated with CNL Fund Advisors Company and KKR Asset Management

(v) FS Energy and Power Fund — $2.9 billion

(vi) FS Energy and Power Fund II — escrow not yet broken

(vii) FS Investment Corporation II — $3.2 billion

(viii) FS Investment Corporation III — $649 million

Affiliated with GSO/Blackstone

(ix) HMS Income Fund — $236 million

Affiliated with Hines Securities and Main Street Capital Corporation

(x) MacKenzie Realty Capital — $14.7 million

Affiliated with MacKenzie Capital Management

(xi) NexPoint Capital — $10 million

Affiliated with NexPoint Advisors and Highland Capital Funds Distributor

(xii) Sierra Income Corporation — $555 million

Affiliated with Medley Capital and SC Distributors

(xiii) VII Peaks Co-Optivist Income BDC II — $50 million

Affiliated with VII Peaks Capital

VI. Esoteric Assets

A. Introduction

1. Banks are less active in the alternative/esoteric asset sector.

2. Funds have been filling the void.

B. Some Characteristics of Esoteric Assets

1. General concept is that the asset is not commoditized.

2. Some characteristics:

   (a) Wider spreads

   (b) More new structuring

   (c) More difficult to find investors and lenders

   (d) More difficult to get a rating

   (e) Fewer deals

   (f) Higher cost of financing

C. Some Examples of Esoteric Assets

1. Timeshare loans

   (a) Real estate- and non-real estate-based

   (b) Structured settlements

   (c) Lotteries

2. Life settlements

   (a) Secondary market

   (b) Tertiary market

   (c) Lending

3. Litigation advances

   (a) Pre-settlements

   (b) Post-settlements

   (c) Law firm loans

   (d) Mass torts

4. Merchant cash advances

   (a) Credit card receipts

   (b) ACH

   (c) Stacking issues

5. Music royalties

   (a) Catalogues

(b) Single artist

(c) Multi-artist

6. Film receivables

(a) Libraries

(b) Slates

The New Regulatory Challenges

I. SEC Examination Trends and Updates

A. Enhanced Examination Capabilities

1. The Securities and Exchange Commission's Office of Compliance Inspections and Examinations ("OCIE") has adopted tools and hired personnel that allow OCIE to more efficiently uncover violations of the Advisers Act during exams.

2. The National Exam Analytics Tool ("NEAT")

(a) NEAT is a sophisticated trade analysis program OCIE utilizes to obtain information about investment advisers' trading patterns and to detect any abnormalities in an investment adviser's trading activity.

(b) NEAT significantly reduces the amount of time OCIE staff needs to spend reviewing trades and allows OCIE staff to review all of an investment adviser's trading activity over the span of several years.

3. As OCIE notes in its Examination Priorities for 2016 list, it now utilizes data analytics in all of its examination initiatives.

4. OCIE has hired new personnel over the past several years that have significant private sector experience working in the private funds industry. As a result, OCIE is now more familiar with the industry and is in a better position to understand the operations of most private fund managers.

B. Common Examination Focus Areas

1. Expense Allocations

(a) OCIE has focused on expense allocations in examinations of both private equity sponsors and hedge fund managers. The Examination Priorities for 2016 list reflects that this will be a continuous area of focus for exams of all private fund managers. Common deficiencies that relate to expense allocation include:

(i) Over-allocation of expenses to one client as opposed to other clients;

(ii) Improperly allocating "mixed use" expenses between the manager and its clients; and

(iii) Charging to clients expenses that are not adequately disclosed to clients or (where such clients are funds) investors in funds.

2. Valuation

(a) OCIE often focuses its examinations on valuation processes and, in particular, on any gaps between the valuation procedures as disclosed to investors and as carried out in practice.

(b) OCIE has focused on situations where managers have changed their valuation methodologies and have either:

(i) Not properly disclosed the change in the valuation methodologies to clients; or

(ii) Failed to effectively adhere to the disclosed valuation methodology.

3. Marketing

Marketing materials have long been an area of focus during exams. During the past year, OCIE has focused on the use of hypothetical performance, cherry picking and the portability of prior performance.

4. Compliance Program

(a) OCIE frequently scrutinizes the compliance program an investment adviser employs, including whether adequate resources are dedicated to the compliance function and whether the firm has a "culture of compliance."

(b) Deficiency letters have identified perceived deficiencies in the knowledge and qualifications of chief compliance officers ("CCOs") in some cases.

5. Insider Trading

(a) Some examinations have focused in particular on the investment adviser's compliance with Section 204A of the Advisers Act. As in prior years, OCIE often closely scrutinizes relationships between the investment adviser and any outside consultants or expert networks. In addition, OCIE has focused on relationships between different buy-side firms, as well as information sharing with investors and the receipt of confidential information at certain industry conferences.

(b) Examination staff have taken the position in many recent examinations that advisers should keep logs of meetings with company management.

II. Developments Regarding Quantitative Investments

A. Regulation AT: Requirements and Definitions

1. The Commodity Futures Trading Commission ("CFTC") has issued a proposed rule for Regulation AT, which would govern algorithmic trading and impose requirements on persons and firms utilizing automatic trading. Regulation AT seeks to: (i) reduce risk; and (ii) increase transparency of "Algorithmic Trading."

2. The proposed rule for Regulation AT defines "Algorithmic Trading" as trading: (i) in any commodity interest (ii) on or subject to the rules of a designated contract market, where:

(a) A *computer algorithm* or system determines whether to initiate, modify or cancel an order, or otherwise makes determinations with respect to certain elements of an order; *and*

(b) Such order, modification or order cancellation is *electronically submitted* for processing on or subject to the rules of a designated contract market.

The full impact of the "electronic submission" element of the final text of Regulation AT will be key to determining the regulation's coverage.

3. Regulation AT will cover a manager that is registered or required to be registered as a commodity pool operator or commodity trading advisor and that engages in Algorithmic Trading. It also covers many categories of persons algorithmically trading for their own account, pulling them into the definition of a "floor trader."

B. Proposed Regulation AT Registration Requirements

Proposed new Rule 170.18 would require managers covered by Regulation AT to become members of at least one registered futures association (i.e., the National Futures Association).

C. Ongoing Regulation AT Requirements

1. Managers covered by Regulation AT would have to adopt a large list of risk controls to address the risks of Algorithmic Trading, including:

   (a) Pre-trade risk controls on items such as the maximum number of order messages, execution frequency, order price and maximum order size parameters; and

   (b) Order cancellation systems.

2. Covered managers would also have to implement a series of development, testing, training and monitoring processes.

3. The most contentious aspects of Regulation AT are requirements to retain the actual algorithmic source code, to ensure preservation of that source code by utilizing a "source code repository," and to make the source code available to examiners (without the need for a subpoena or other "good cause" requirements).

4. The proposed rule is in a comment period and various industry groups are currently considering the most effective means of providing feedback to the CFTC.

D. MiFID II Reforms

1. The EU legislative package consisting of a recast Markets in Financial Instruments Directive and the Markets in Financial Instruments Regulation (together, "MiFID II") is due to come into force on Jan. 3, 2017. The European Commission has recently proposed to delay the transposition of MiFID II reforms by one year (until 2018), citing concerns around the feasibility of the implementation by member state regulators, and the requirements to build complex IT systems necessary to accommodate the new pre- and post-trade transparency regime in the time remaining until the original deadline. It is likely that the legislative acts providing for such a delay will be published in January 2016.

2. MiFID II will have significant operational and trading infrastructure implications for EU asset managers. U.S. managers who access EU trading venues, trade with EU counterparties or provide managed account services to EU clients are also likely to be affected by the MiFID II reforms.

3. *Algorithmic and High-Frequency Trading*: MiFID II introduces a comprehensive regime of new organizational and systems resilience requirements for EU firms that engage in algorithmic and high-frequency trading. The definition of algorithmic trading in MiFID II is very broad and covers all forms of automated trading, not only high-frequency or "quant" strategies. Trading venues that allow direct electronic access and EU investment firms that provide their clients with direct market

access or sponsored access will be subject to extensive systems resilience, risk control and trade monitoring obligations. U.S. managers who currently benefit from direct market access or sponsored access to EU trading venues may be affected by the new requirements applicable to their sponsoring firms. As a result of MiFID II implementation, sponsoring firms are likely to revise the eligibility and due diligence requirements for direct electronic access and update the terms on which direct electronic access will be provided.

4. Other key MiFID II reforms that are likely to have an effect on U.S. managers include:

   (a) *Transparency and Market Infrastructure Reforms*: MiFID II creates new transparency regimes for non-equity financial instruments, such as bonds, structured finance products and derivatives. In addition, the existing pre-trade transparency waivers for equity instruments will be modified which, among other things, will have a direct effect on trading in dark pools. As a result of MiFID II, certain EU trading counterparties may be required to alter their business models or become authorized as a trading venue or a so-called systematic internalizer. Managers should analyze the impact of the reforms on their trading strategies and should engage with their EU trading counterparties to understand their status under MiFID II, their obligations to publish prices, and any changes to their terms of business or usual trading practices that may result from MiFID II.

   (b) *Commodity Derivatives Position Limits*: MiFID II introduces new position limits, position management powers, and position reporting regimes for commodity derivatives traded on EU trading venues and economically equivalent OTC contracts. Managers who trade commodities derivatives or emission allowances should assess the impact of these reforms on their trading strategies.

   (c) *Provision of Investment Services to EU Clients*: Non-EU managers who provide managed account and other investment services to EU clients should be aware that certain EU member states currently regulate provision of these services in their jurisdictions, even where the non-EU manager does not have a physical presence in their jurisdictions.

   (d) The so-called "third-country access" provisions in MiFID II create a new regime allowing non-EU managers to register with the European Securities and Markets Authority ("ESMA") in order to provide such services to professional clients, subject to the EU Commission first adopting an equivalence decision in respect of the home jurisdiction of the non-EU manager. MiFID II also specifies that member state regulators may require non-EU firms that provide services to so-called "elective professional clients" (e.g., local authority pension funds) to establish a branch in that member state and to obtain a license from the local member state regulator. Transposition of MiFID II third-country access provisions into local law of EU member states is likely to result in further restrictions on the provision of "cross-border" services in certain EU jurisdictions.

   (e) MiFID II includes a "reverse solicitation" exemption to these registration requirements that is similar to the one in the Alternative Investment Fund Managers Directive ("AIFMD") but defined more narrowly.

   (f) *Access to EU Trading Venues*: One further aspect of the third-country provisions is that some EU member states may restrict the ability of non-EU firms to become members of regulated exchanges in their jurisdictions or disallow such firms to take advantage of direct market access or sponsored access without obtaining a local license.

III. Cybersecurity

A. Updates on Cybersecurity Guidance

1. OCIE announced in January 2015 that it was going to begin focusing more on cybersecurity during exams and that it would conduct several sweep exams on cybersecurity in 2015.

2. OCIE issued a Risk Alert in September 2015 that provided additional information on this focus and noted that OCIE would be testing to assess the implementation of firm procedures and controls for cybersecurity.

3. In April 2015, the staff of the SEC's Division of Investment Management issued a guidance update outlining some of the features that it suggests investment managers adopt in order to address cybersecurity risk (to the extent they are relevant). This guidance can be summarized as a three-step approach whereby the SEC staff recommends that investment managers:

   (a) Use periodic assessments to assess threats, vulnerabilities and defensive measures currently in place;

   (b) Design a strategy to prevent, detect and respond to cybersecurity threats, specifically utilizing data encryption, firewalls, restrictions on the use of movable storage media, intrusion monitoring software, network segregation and "system hardening"; and

   (c) Implement the strategy the investment manager develops through customized written policies and procedures, either as a stand-alone document or as part of other policies designed to comply with applicable aspects of the securities laws.

4. In August 2015, the NFA submitted to the CFTC a proposed interpretive notice that would apply to NFA Compliance Rules 2-9, 2-36 and 2-49, which generally require firms to diligently supervise their employees and agents or their businesses. The NFA's proposal provides cybersecurity guidance but generally focuses on areas similar to those in OCIE's Risk Alert.

B. Enforcement Activity Relating to Cybersecurity

1. The SEC has not yet brought an enforcement action against a private fund manager for violations of the securities laws arising from cybersecurity-related matters. However, the SEC brought an enforcement action this year against an investment adviser for the first time under Regulation S-P as a result of a cyber breach that resulted in a hacker obtaining the personally identifiable information ("PII") of over 100,000 individuals, including some of the investment adviser's clients.

2. In *R.T. Jones Capital Equities Management, Inc.*, the SEC alleged that R.T. Jones Capital Equities Management Inc. ("R.T. Jones") failed to adopt written policies and procedures reasonably designed to protect customer records and information in violation of Rule 30(a) of Regulation S-P. R.T. Jones was not itself hacked; its third-party vendor was hacked, and as a result, PII of over 1000,000 individuals was exposed. The hack occurred in 2013, which was before any statement or initiative by the SEC relating to cybersecurity for investment advisers. Regardless, the SEC found that R.T. Jones had not adopted sufficient policies and procedures regarding the security and confidentiality of information stored by third-party service providers. The SEC imposed a $75,000 civil penalty.

3. To mitigate future risks, R.T. Jones also agreed to appoint an information security manager to oversee data security and to hire a cybersecurity firm to provide ongoing reports and advice, and

the firm also implemented a written information security policy that included maintaining sensitive information in an encrypted format and installing a new firewall.

C. Mitigating Cybersecurity Threats

1. Establishing a Formal Program

(a) Managers should adopt a written policy and utilize outside consultants to assist with day-to-day cybersecurity monitoring as necessary.

(b) Managers should not adopt any consultant's standard policies wholesale, but must be careful to tailor any policies or procedures to their business.

(c) The SEC and CFTC have noted several elements that they expect to see in a cybersecurity policy, including but not limited to: (i) multifactor authentication; (ii) firewalls; (iii) dynamic updating of personnel access rights; (iii) patch management practices; (iv) vulnerability scans; and (v) penetration testing.

2. Oversight

Managers should involve senior personnel throughout the firm in cybersecurity matters. Managers should also document the oversight and involvement of senior management and fund directors in real time.

3. Risk Assessments

(a) Risk assessment (and response) protocols should be treated as a continuous process. Managers should not wait for the annual compliance review to assess cybersecurity risks.

(b) If a risk is identified, managers should consider specifically addressing that risk in the firm's cybersecurity policies and procedures (as well as noting that those procedures are designed to address that risk).

4. Access Rights and Controls

Managers should perform an information transfer channel inventory and analysis on a periodic basis and compare the volume of data transmitted (by channel) on a relative basis and over time. Corrective action should be taken to limit or close transmission channels that present an unnecessary or unacceptable risk of theft or loss.

5. Vendor Management

Managers should be performing due diligence of vendors when they are selected, negotiating protections into vendor contracts related to access to firm networks or data (including the breach of confidential information), and monitoring vendors after they are on-boarded; this process should be documented. Managers should also ensure that they have "written contingency plans [with vendors] concerning ... issues that might put the vendor out of business or in financial difficulty."[135]

6. Incident Reponses and Recovery

[135] Securities and Exchange Commission, OCIE's 2015 Cybersecurity Examination Initiative (Sept. 15, 2015), *available at* www.sec.gov/ocie/announcement/ocie-2015-cybersecurity-examination-initiative.pdf.

Because examiners will be expecting to discuss incident responses, it is important to contemporaneously document each incident and the manager's response. As this can be challenging for compliance personnel without extensive technical training or experience, it underscores the need to partner with the information security staff from as early a point in time as possible.

7. Training

   Managers should be aggressive in scheduling training sessions and in documenting their use and effectiveness. Thought should also be given to tailoring training by employee function and classification.

D. Cybersecurity and Investor Due Diligence

1. Cybersecurity deals with enterprise-wide risk and should be accorded resources and attention as such. In addition to the problems associated with a potential SEC enforcement action relating to cybersecurity, it is important to note that an information security breach could have a substantial impact on both the firm's ability to maintain operations as well as attract new capital.

2. Cybersecurity has become a significant focus area during investor due diligence as investors begin to take into account both the greater likelihood of cyber attacks and the significant risk they pose to firms.

3. During diligence meetings, managers should be prepared to outline their cybersecurity policies and procedures as well as list any vendors they may use to assist in performing day-to-day cybersecurity functions.

IV. Enforcement Actions

A. The SEC pursued enforcement actions against several noteworthy firms based on various types of conflict of interest.

1. *In the Matter of Kohlberg Kravis Roberts & Co. L.P.* (June 29, 2015)

   (a) The SEC alleged that Kohlberg Kravis Roberts & Co. LP ("KKR") breached its fiduciary duty to clients by misallocating expenses. KKR incurred $338 million in expenses, including diligence, research, travel and professional fees, related to potential investment opportunities that ultimately are unsuccessful or go unexecuted. These broken deal expenses can be reimbursed through fee-sharing arrangements with its funds and co-investors. The SEC alleged that KKR improperly allocated these expenses by failing to allocate any of them to its co-investors (many of whom were internal firm personnel) and additionally failed to disclose in limited partnership agreements or otherwise that it did not allocate any broken deal expense to its co-investors. By doing so, KKR breached its fiduciary duty as an investment adviser and Section 206(2) of the Advisers Act.

   (b) The SEC also charged KKR with failing to adopt and implement a written compliance policy or procedure regarding its fund expense allocation practices in violation of Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder. The SEC discovered these violations through a 2013 OCIE Compliance Examination.

   (c) KKR agreed to pay over $28 million in total to settle the action.

2. *In the Matter of Blackstone Management Partners L.L.C., et al.* (Oct. 7, 2015)

   (a) The SEC alleged that Blackstone Management Partners LLC ("Blackstone") and certain of its affiliates breached their fiduciary duty to clients by inadequately disclosing certain information to funds and limited partners. Specifically, Blackstone failed to disclose a discount it received on legal fees being provided to the advisory entities but not to the funds. In addition, the SEC alleged that Blackstone failed to disclose its ability to accelerate monitoring fees to be paid in the future prior to the submission of capital commitments. The SEC alleged that these accelerating fees had the effect of reducing the value of the portfolio companies prior to their sale. In doing so, the SEC alleged that Blackstone violated Section 206(2) and Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder.

   (b) The SEC further alleged that Blackstone violated Section 206(4) and Rule 206(4)-7 for inadequate written policies and procedures reasonably designed to prevent conflicts of interest and failure to disclose information regarding monitoring fees.

   (c) To settle the matter, Blackstone agreed to pay $26,225,203 in disgorgement, $2,686,553 in prejudgment interest, and a $10-million civil penalty.

3. *In the Matter of BlackRock Advisors, LLC and Bartholomew A. Battista* (April 20, 2015)

   (a) The SEC alleged that BlackRock Advisors LLC ("BlackRock") failed to disclose that one of its portfolio managers was a general partner of and had a substantial investment in a company that formed a joint venture with a portfolio company. The portfolio manager caused BlackRock funds to increase the amount of their invested capital in the joint venture with his company. The SEC stated that this created a conflict of interest for BlackRock and that failure to disclose that conflict of interest resulted in a breach of BlackRock's fiduciary duty to its clients.

   (b) BlackRock was also charged with failing to adopt and implement adequate compliance policies and procedures, and its CCO was charged with causing that violation. Both BlackRock and the CCO were charged with causing the funds' failure to have BlackRock's CCO report to the board of directors the portfolio manager's violations of BlackRock's private investment policy.

   (c) As part of the settlement, BlackRock agreed to hire an independent compliance consultant. BlackRock agreed to pay a civil penalty of $12 million, and BlackRock's CCO agreed to pay a civil penalty of $60,000.

B. CFTC Enforcement Actions

1. The CFTC and the futures exchanges have become very active in seeking enforcement actions against market participants for both technical violations as well as more substantive manipulation and insider-trading violations.

2. The CFTC, in particular, has been asserting its litigation powers across the breadth of its jurisdiction. Several noteworthy enforcement actions include:

   (a) *In the Matter of Arya Motazedi* (Dec. 2, 2015)

(i) In the *Motazedi* case, the CFTC settled its first-ever insider-trading case, relying on new powers granted to it under the Dodd-Frank Act and embodied in CFTC Regulation Section 180.1 ("Rule 180.1").

(ii) According to the CFTC, Motazedi, a proprietary gasoline and energy trader at an unnamed public company in Chicago, had access to confidential, proprietary information concerning his employer's proprietary trading in energy commodities (e.g., timing, amounts and prices), and he used that knowledge to: (i) enter "opposite side" orders that matched with his employer's orders at least 34 times (causing the employer's account to buy energy futures at higher prices and sell at lower prices, profiting Motazedi and harming his employer), at least some of which were designed as "round trip" transactions (where both sides bought and sold with the other and neither party experienced a net change in its positions); and (ii) "front run," on at least 12 occasions, his employer's orders (allowing Motazedi to benefit from any subsequent price movement caused by the subsequent execution of the employer's oil and gas futures orders).

(iii) The CFTC issued a variety of sanctions against Motazedi, including:

(1) A "cease and desist" order;

(2) The requirement that Motazedi pay $216,955.80 in restitution;

(3) The requirement that Motazedi pay a civil monetary penalty of $100,000;

(4) A permanent ban on Motazedi's trading of commodity interests; and

(5) A permanent ban on Motazedi's registering with the CFTC as a futures professional in any capacity.

(b) *In the Matter of Total Gas & Power North America, Inc. and Therese Tran* (Dec. 7, 2015)

(i) The CFTC settled attempted manipulation charges where a trader allegedly attempted to manipulate the monthly index settlement prices of gas at four hubs which would in turn benefit the swap positions held by the trader.

(ii) This case marked the second time that the CFTC relied on Rule 180.1 (the first time was in *Motazedi*, discussed above).

(c) *In the Matter of JPMorgan Chase Bank, N.A.* (Dec. 18, 2015)

(i) The CFTC settled charges with JPMorgan for failure to disclose certain conflicts of interest to clients of its wealth management business. Specifically, JPMorgan allegedly failed to disclose its preference for investing its clients' funds in investment vehicles that provided additional fees or incentives to JPMorgan. JPMorgan agreed to a $100-million fine.

(ii) The *JPMorgan* case is notable because it so closely resembles the conflict of interest cases that the SEC has traditionally brought, and (together with the Rule 180.1 cases discussed above) may well be a harbinger of a shift to SEC-style enforcement.

C. European Union Enforcement Actions

1. In the past year, there has been a significant increase in enforcement actions taken by European Union ("EU") member state regulators for late filings of position disclosures (for both short and long positions) and uncovered short sales.

2. EU Short Selling Regulation. The requirements of the EU Short Selling Regulation[136] include the following:

    (a) *Equities*: Net short positions of 0.2 percent (and each 0.1 percent above that) must be notified to the local EU regulator for the market. Net positions of 0.5 percent (and each 0.1 percent above that) must be disclosed publicly.

    (b) *Sovereign Debt*: Net short positions must be disclosed to the relevant EU regulator if the following thresholds are crossed: 0.1 percent if the total amount of outstanding debt is less than 500,000 euros; 0.5 percent if outstanding debt is more than 500 million euros. Thresholds for each sovereign issuer are published on a quarterly basis.[137]

    (c) *Naked Short Selling*: The Short Selling Regulation prohibits uncovered short sales in shares and sovereign debt. The Short Selling Regulation specifies the types of arrangements (e.g., pre-borrow or "locate") that provide eligible "cover" for short positions.

    (d) *EU Sovereign CDS*: "Uncovered" sovereign credit default swap ("CDS") transactions are prohibited. Managers are required to have procedures in place to document that the sovereign CDS position is used to hedge a corresponding exposure to sovereign debt or another exposure that meets the correlation tests set out in the Short Selling Regulation.

    (e) *Short Selling Bans and Emergency Measures*: EU member states may from time to time bring in temporary bans or other restrictions on short selling. Announcements of temporary bans are published on the website of the local regulator and on ESMA's website.[138]

    (f) *Pre-Registration for Reporting*: Most EU member states require prior registration for the purposes of making short-selling filings, and it can take more than 24 hours to obtain reporting log-in or registration details. Managers should consider registering in advance in all EU member states where they may need to report in order to ensure that filings can be submitted before the deadline (3:30 pm local time on the following trading day) when required.

    (g) *Sanctions and Penalties*: ESMA has published a list of administrative measures and sanctions applicable in EU member states to infringements of the Short Selling Regulation.[139]

D. EU Major Shareholding Disclosure Requirements

1. All EU jurisdictions require notification of significant long positions. Notifications are made to the issuer and the local regulator for the market and published by the issuer. Initial notification thresholds range from 1 percent to 5 percent depending on the local rules; incremental disclosure obligations (which can also range between 1 percent and 5 percent) also apply.

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[136] Regulation EU 236/2012.

[137] https://www.esma.europa.eu/regulation/trading/short-selling.

[138] *See id.*

[139] https://www.esma.europa.eu/sites/default/files/library/list_of_administrative_measures_and_sanctions.pdf.

2. As a result of the implementation of the EU Transparency Directive Amending Directive[140] ("TD Amending Directive") in November 2015, a number of changes have been made to the major shareholding disclosure regimes of EU member states. Notably, those member states (e.g., Spain) that did not previously require disclosure of long positions held through cash-settled equity swaps (or contracts for difference ("CFDs")) or convertible bonds now require such positions to be taken into account when calculating the total size of the position. ESMA has published an indicative list of financial instruments subject to the disclosure obligations.[141]

3. ESMA has published a standard form for notification of major holdings, and some member states have now replaced their old reporting forms with the ESMA template.[142]

4. The TD Amending Directive includes a regime of administrative sanctions and penalties for breaches of the disclosure requirements. The maximum penalty for breaches by a legal entity is 10 million euros or 5 percent of the turnover.

V. Personal Liability

A. Recent SEC Enforcement Actions Against Individuals

1. The SEC has more frequently been bringing enforcement actions against CCOs of investment advisory firms.

2. In terms of actual enforcement actions, the SEC has come down on both sides of the CCO liability front in 2015.

   (a) In *Pekin Singer Strauss Asset Management, Inc. et al.* (June 23, 2015), the SEC alleged that an investment manager had widespread and significant compliance failures, but the CCO was not responsible for them and was not charged by the SEC. To the contrary, the CCO had repeatedly informed upper management that the firm needed to strengthen its compliance program and needed more resources dedicated to compliance. SEC officials have cited this case as an example of a competent CCO not being held liable for the compliance failures of his or her company.

   (b) In *BlackRock Advisors, LLC*, the CCO agreed to pay a $60,000 civil penalty for causing his firm's alleged compliance-related violations — failing to adopt and implement written compliance policies and procedures reasonably designed to monitor and disclose conflicts related to outside business activities of firm employees. Specifically, the CCO was held partially responsible for a portfolio manager and the principals of the firm failing to disclose a conflict of interest to its funds. Additionally, the CCO was charged with causing some of the adviser's funds to violate Rule 38a-1(a) by not disclosing a "material compliance matter to the funds" boards.

   (c) In *SFX Financial Advisory Management Enterprises, Inc. and Eugene S. Mason* (June 15, 2015), a CCO was also charged with causing his firm's alleged failure to implement compliance policies, as well as failure to conduct an annual compliance review, and causing a material misstatement in a Form ADV filing, all of which were related to firm principals allegedly

[140] Directive 2013/50/EU.

[141] https://www.esma.europa.eu/regulation/corporate-disclosure/transparency-directive.

[142] *Id.*

misappropriating client funds through their unilateral signatory power over client bank accounts. Notably, the CCO was held responsible for not implementing policies and procedures reasonably designed to prevent this misappropriation, and for failing to adequately implement the existing policies. The CCO was charged regardless of the fact that when he learned that the misappropriation had occurred, he conducted an internal investigation that resulted in the firing of the individual who misappropriated funds and a referral to criminal authorities. In addition, the CCO was charged with not conducting an annual review in the midst of the internal investigation.

(d) In *Sands Brothers Asset Management et al.* (Nov. 19, 2015), the SEC settled charges with an adviser who allegedly failed to properly distribute audited financial statements to investors in violation of Rule 206(4)-2 ("the Custody Rule"). The CCO was charged with aiding and abetting the alleged violation and failing to implement adequate policies and procedures reasonably designed to prevent these types of violations. In this case, however, the CCO raised these issues directly with management but was ineffective in persuading management to take actions to remedy deficiencies pointed out by the SEC staff.

3. A recent public memorandum by Deputy Attorney General Sally Yates — the second highest ranking member of the Department of Justice ("DOJ") — announced that the DOJ was formalizing in writing steps intended to strengthen its pursuit of individual corporate wrongdoing, which necessarily includes violations by investment advisers and their employees. Among other things, Yates' memorandum states that in order for an entity to receive credit for cooperating with a government investigation, it must provide all relevant facts relating to the individuals responsible for the misconduct, and all criminal and civil investigations should focus on individuals and their potential liability from the inception of the investigation. Other government regulators, including the SEC and the CFTC, have expressed similar views.

4. All employees — not just CCOs — have a personal interest in preventing compliance failures. Principals and portfolios managers and analysts alike must take personal responsibility for ensuring that the investment adviser is complying with its fiduciary obligations, and that its compliance policies and procedures are properly crafted to address any emerging risks.

5. In a speech in October 2015, Andrew J. Donohue, the SEC's chief of staff, outlined a number of areas that CCOs should focus on in performing their duties:

(a) The various laws and regulations that govern the manager and its business;

(b) The manager's compliance policies and procedures and how they are applied and monitored;

(c) How the manager identifies conflicts of interest, the frequency of any conflicts review, and how conflicts are disclosed, mitigated or resolved;

(d) The manager's internal operations, supervisory regime, and structure and interdependencies;

(e) The power and limitations of the manager's compliance and other technology platforms;

(f) The manager's clients, the offering in which they are invested, and their investment objectives;

(g) The types of investment products and strategies in the manager's portfolio;

(h) The practices and regulations in the various markets in which the firm operates; and

(i) The manager's performance across its various products, and how that compares with the corresponding advertising and marketing efforts and materials.

B. CCO Liability Issues in the United Kingdom

1. *FCA Final Notice: Anthony Rendell Boyd Wills*

In March 2015, the U.K. Financial Conduct Authority ("FCA") imposed a financial penalty on Wills, a former compliance officer at Bank of Beirut, for allegedly failing to deal with the FCA in an open and cooperative way and failing to disclose appropriately to the FCA information of which it would reasonably expect notice.[143] The FCA found that the information provided by Wills was misleading and that he had failed to inform the FCA of the deficiencies in the compliance monitoring identified by a third-party compliance audit and the fact that the compliance monitoring plan had not been fully implemented at the time of the communication. On announcing the fine, Georgina Philippou, acting Director of Enforcement and Market Oversight at the FCA, noted: "We are reliant on compliance officers and internal audit to act as an important line of defense, to support effective regulation at firms and to show backbone even when challenged by their colleagues."

2. New Senior Managers and Certification Regime

In October 2015, the HM Treasury announced[144] its plans to extend the Senior Managers and Certification regime to all sectors of the financial services industry, including FCA-authorized asset managers, replacing the existing approved persons regime. The new Senior Managers Regime is currently expected to apply to asset managers from 2018 and will have the following key features:

(a) A new statutory duty for senior managers to take reasonable steps to prevent regulatory breaches in their areas of responsibility;

(b) An approval regime focused on senior management, with requirements on firms to prepare robust documentation on the scope of these individuals' responsibilities (note that a CCO would be considered a "senior manager" for the purposes of the new regime);

(c) A requirement on firms to certify as fit and proper any individual who performs a function that could cause significant harm to the firm or its customers (e.g., portfolio managers or traders who are not also senior management), both on recruitment and annually thereafter; and

(d) A power for the FCA to apply enforceable Rules of Conduct to any individual who can impact the FCA's statutory objectives.

VI. Marketing Under the AIFMD

The AIFMD[145] has been implemented in a majority of member states of the European Economic Area ("EEA"). The transitional provisions for certain marketing activities that were available in some EEA member states expired on July 22, 2014.

A. Reverse Solicitation

143 https://www.fca.org.uk/static/documents/final-notices/anthony-rendell-boyd-wills.pdf.

144 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/468328/SMCR_policy_paper_final_15102015.pdf.

145 Directive 2011/61/EU.

1. Many U.S. managers continue to rely on the reverse solicitation exception when dealing with EEA investors. This exception is available in all EEA member states under the local legislative measures implementing the AIFMD. In broad terms, "marketing" for AIFMD purposes means an offer or placement made at the initiative of the alternative investment fund manager (or the "AIFM") or on behalf of the AIFM (e.g., by a placing agent).

2. "Marketing" excludes offers made at the initiative of the investor (or through reverse enquiry).

3. The boundaries of the reverse solicitation concept are most commonly tested in four scenarios:

   (a) Pre-marketing (e.g., initial meetings or calls with prospective investors);

   (b) Interactions with existing investors in respect of new investment opportunities;

   (c) Interactions with consultants and other third parties; and

   (d) Capital introduction by prime brokers (as discussed below).

4. Typical compliance measures that are being taken by managers to ensure that they able to rely on this exception include: (i) obtaining "own initiative" certifications and written requests for information from potential investors; (ii) removing any EU-based investors from distribution lists, except where a specific request for fund information has been received; (iii) deleting any references to new fund launches from newsletters sent to existing investors; and (iv) restricting the ability of third-party distributors, introducers or placement agents to market in Europe.

B. Compliance with National Private Placement Regimes

1. An increasing proportion of U.S. managers have either already registered their funds under the national private placement regimes of one or more of the EEA countries or are in the process of assessing the feasibility of such registrations. There are three key drivers for this trend: (i) the desire to launch new products and the need not to miss out on the EU altogether in those launches; (ii) pressure from placement agents who do not wish to be restricted from marketing in the EU; (iii) certain institutional investors in the EU asking managers to represent that there has not been a breach of local marketing restrictions. All of these factors are causing some managers to be more cautious.

2. In those EEA countries where a national private placement regime ("NPPR") is available, the local law has been amended to incorporate the minimum elements of the private placement rules set out in the AIFMD. These include:

   (a) The existence of cooperation arrangements between the home state regulator of the alternative investment fund ("AIF"), the home state regulator of the manager (or AIFM) and the EEA member state where the marketing takes place — to this end, the SEC, CFTC and the Cayman Islands Monetary Authority ("CIMA") have entered into cooperation agreements with a majority of member state regulators;

   (b) The AIFM must undertake to comply with the initial and ongoing investor disclosure obligations specified in the AIFMD; and

   (c) The AIFM must comply with Annex IV regulatory reporting obligations (similar to SEC Form PF).

3. For managers that acquire "control" of unlisted companies established in the EU or issuers of shares admitted to trading in the EU, an additional obligation to comply with the so-called "asset-stripping rules" applies. These rules: (i) impose restrictions on all forms of distributions by the EU portfolio company within the first 24 months of the AIFM acquiring control; and (ii) require the AIFM to make certain disclosures and notifications to various stakeholders.

4. Some countries have included additional requirements in their NPPRs, an approach often referred to in the EU as "gold-plating." These "gold-plating" measures range from requirements to apply for prior approval of the local regulator (e.g., Germany) before commencing marketing activities (a process that can take up to four months) to appointment of service providers to the AIF (e.g., a custodian and administrator) to carry out the functions of a "depositary" specified in the AIFMD (e.g., Denmark and Germany).

5. There is also a degree of variation in the local approaches to investor disclosure and regulatory reporting elements of the AIFMD (e.g., a requirement to produce a country supplement). As regards Annex IV reporting, some EEA regulators have announced that non-EU AIFMs with master feeder structures would only need to disclose feeder-level information in their Annex IV filings with no look-through to the positions of the underlying master fund. Other member state regulators expect a separate report to be submitted in respect of the master fund.

6. The most popular jurisdictions for NPPR registrations are currently the United Kingdom, the Netherlands, Finland, Sweden and Norway. Some countries (e.g., France and Italy) do not currently have an NPPR allowing non-EU AIFMs to market open-ended funds, which means that hedge fund managers may only make offers in response to a reverse enquiry in these countries.

C. Third-Country Marketing Passport

1. The AIFMD includes a so-called "third-country passport" mechanism (that is, a marketing passport for non-EU managers and non-EU funds). This passport, when available, would allow a non-EU fund to be marketed to professional investors throughout the EEA, including in circumstances where there is no NPPR available.

2. For the third-country passport to become available, ESMA must first produce a positive opinion on the extension of the passport to both the jurisdiction of the manager (e.g., the United States) and the fund (e.g., the Cayman Islands). Following such positive advice, the EU Commission would legislate to allow the third-country passport to be extended.

3. ESMA produced its first opinion and technical advice to the EU Commission on the viability of such a third-country passport in July 2015.[146] Positive advice was provided with respect to Guernsey, Jersey and Switzerland. No decision has been reached and some concerns were expressed with respect to Hong Kong, Singapore and the United States. ESMA continues with its assessment of the United States and plans to review the Cayman Islands in the next phase of the equivalence assessments.

4. If the third-country passport becomes available, the national private placement regimes may be abolished within three years. Until then, non-EU managers marketing in the EEA can choose between a passport and NPPR (where available). Some countries (e.g., Germany) have already announced that they intend to repeal their NPPR as soon as the third-country passport becomes

[146] For more information, see the SRZ *Alert*, "AIFMD Update: ESMA Advice on Extension of Marketing Passport Published," *available at* www.srz.com/AIFMD_Update_ESMA_Advice_on_Extension_of_Marketing_Passport_Published/.

available. Under the AIFMD, a U.S. manager who opts-in to the third-country passport would be required to register with an EU “member state of reference” (e.g., the country where it undertakes most of its marketing activities) and comply with the whole of the AIFMD. This would mean, among other things, a requirement to appoint an eligible depositary for the funds marketed in the EEA that is located either in the jurisdiction of the manager (e.g., the United States) or the jurisdiction of the fund (e.g., the Cayman Islands).

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