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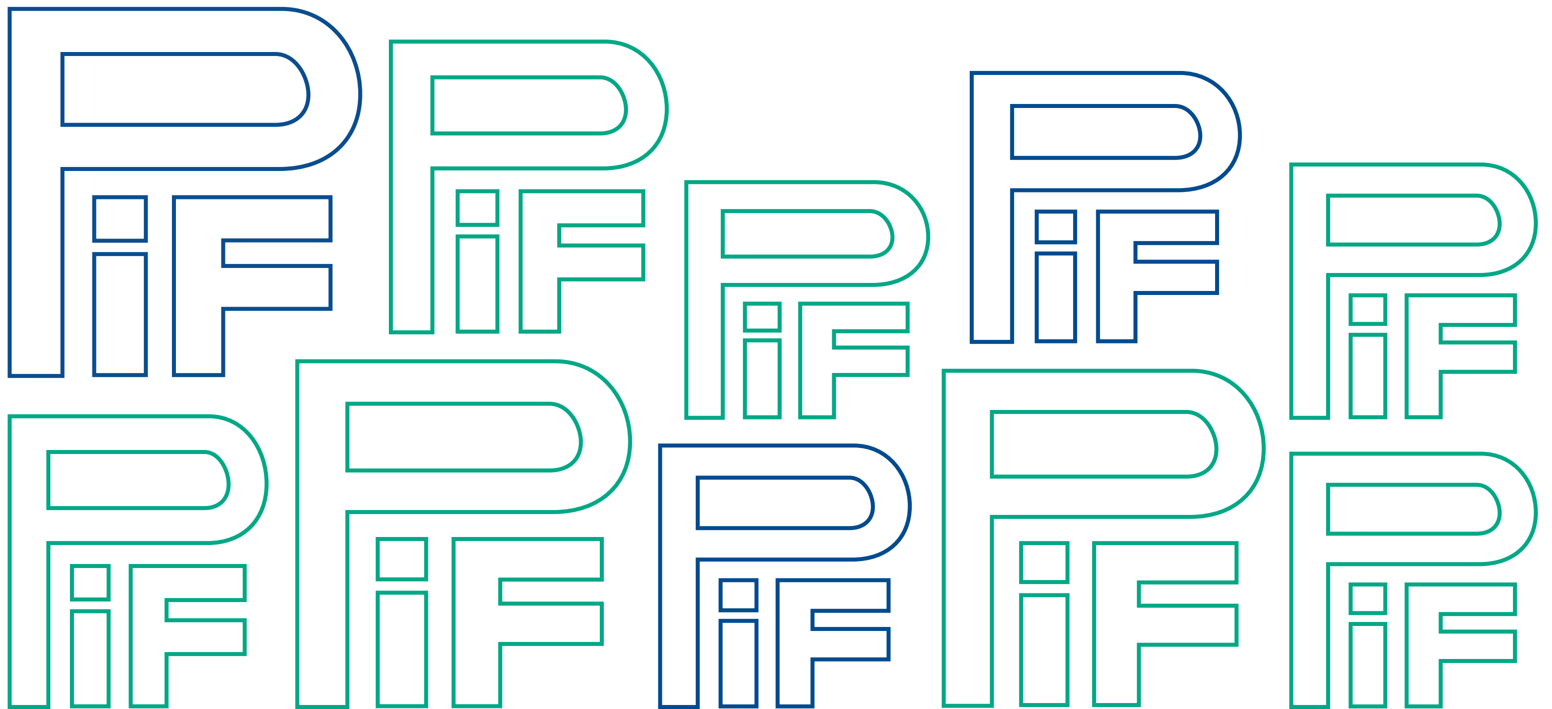
26TH ANNUAL

PIF PRIVATE INVESTMENT FUNDS SEMINAR

January 17, 2017



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Brian T. Daly

Brian advises hedge, private equity and real estate fund managers on regulatory, compliance and operational matters. He has extensive experience designing and improving compliance processes and organizational systems and helps clients navigate their initial and ongoing regulatory compliance obligations under the rules and regulations of the Securities and Exchange Commission, the Commodity Futures Trading Commission, and the National Futures Association. Brian also regularly represents clients in enforcement actions, regulatory examinations, trading inquiries, and in seeking no-action or similar relief. Having spent nearly a decade in-house as general counsel and chief compliance officer of several prominent investment management firms, Brian is well-versed in the wide range of legal and business challenges facing investment advisers, commodity pool operators and commodity trading advisers.

Brian is a recognized leader in advising alternative investment fund managers on regulatory and compliance matters and is well-known for his thought leadership in this area. He also regularly represents managers in examinations, investigations, and enforcement actions in both the securities and the commodity futures sectors. *Chambers Global* and *Chambers USA* list Brian as a “leading individual” in investment funds, noting that he is “especially skilled at assisting clients with the development of strategic compliance programs.” Interviewees also praise him for knowing “what it’s like on the ground” and for providing “practical and meaningful advice.” In addition to hosting SRZ webinars, participating in firm-sponsored seminars and workshops, and authoring *SRZ Client Alerts* and *SRZ White Papers*, he authored “New Form ADV: The Impact on Private Fund Advisers” and “The New FINRA Registration Requirement for Algorithmic Traders: Implications for Broker-Dealers and Investment Advisers,” published in *The Hedge Fund Journal*. His recent speaking engagements addressed topics including current trends and challenges in systematic and quant strategies, and managing attorney-client privilege. 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, as well as 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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Harry S. Davis

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 on a wide range of topics, including SEC examinations and enforcement actions, how hedge funds can protect themselves against insider trading, limiting liability for compliance officers, and civil litigation relating to securities enforcement.

Harry holds a J.D., *magna cum laude*, from Cornell Law School, where he was Order of the Coif, and a B.A. from Johns Hopkins University.

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Jacob Preiserowicz

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. He co-authored "The CFTC Brings (and Settles) Its First Insider-Trading Case: Implications for All Private Fund Managers," published in *The Hedge Fund Journal*, and is a contributor to *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press).

Jacob earned both J.D. and M.B.A. degrees from Fordham University. He was the Notes & Articles editor of the *Fordham Journal of Corporate & Financial Law* and received *cum laude* honors from the Fordham University Graduate School of Business. He received his B.A., *cum laude*, from Brooklyn College.

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David focuses his practice on representing broker-dealers, investment advisers and hedge funds in connection with matters arising under federal and state securities laws and self-regulatory organization rules. His practice encompasses a wide range of regulatory issues affecting financial services firms and institutional investors, including market access; equity and fixed-income trading practices; order handling and execution issues; market making; broker-dealer and alternative trading system registration; outsourcing; audit trail and trade reporting requirements; and creation and distribution of research reports and other communications with the public. He also advises clients in connection with mergers and acquisitions involving broker-dealers. In addition to regulatory counseling, David represents clients in enforcement proceedings and conducting internal investigations. He has played an important role in matters involving, among other things, specialist trading, market making, agency trading, market access, research, broker-dealer registration and the self-regulatory function of securities exchanges. Prior to entering private practice, David was a special counsel at the U.S. Securities and Exchange Commission's Division of Trading and Markets and counsel to Commissioner Isaac C. Hunt, Jr.

Recognized as a leading financial services regulation lawyer by *Chambers USA*, David is the co-author of "The New FINRA Registration Requirement for Algorithmic Traders: Implications for Broker-Dealers and Investment Advisers," published in *The Hedge Fund Journal*.

David received his J.D. from New York Law School, where he was articles editor of the *New York Law School Journal of International and Comparative Law*, and his B.B.A. from Hofstra University.

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Peter H. White

Pete concentrates his practice on representing corporations and executives in criminal and related civil and administrative matters, including grand jury investigations, internal investigations, SEC enforcement proceedings, False Claims Act and qui tam lawsuits, and shareholder class actions. Pete has litigated disputes involving accounting and securities fraud, Foreign Corrupt Practices Act violations, government program fraud, false claims and statements, antitrust violations, public corruption, tax evasion, insider trading, environmental violations and other claims. A former Assistant U.S. Attorney for the Eastern District of Virginia and the District of Columbia, Pete has served as lead counsel in over 80 federal and local jury trials and many more bench trials, and has had the distinction of serving as a law clerk to the Honorable Richard L. Williams of the Eastern District of Virginia.

Pete is the recipient of the Department of Justice Director's Award for Superior Performance as an Assistant U.S. Attorney and has performed with comparable skill as a private practitioner. Over the past 17 years, Pete has been lead trial counsel for individuals charged with federal fraud charges in public corruption, government programs and public company accounting. He has prevailed on over 95 percent of all charges that have gone to trial, and in three of his last four trials, all fraud charges have resulted in dismissal or acquittal. In 2015, he represented an individual charged with 60 federal fraud felony counts. The defendant was acquitted of all charges by the jury. Among the many publications that have recognized him as a leading litigator are: *The Best Lawyers in America*, *Chambers USA*, *Ethisphere: Attorneys Who Matter*, *The Legal 500 United States*, *Washington DC Super Lawyers*, *Washingtonian's* "Washington's Top Lawyers" and *The Washington Post*. Pete was recently featured in "Trial Pros: Schulte's Peter White," published by *Law360*, and co-authors the "Civil and Criminal Enforcement" chapter of the *Insider Trading Law and Compliance Answer Book* (Practising Law Institute). He has spoken widely on insider trading, securities enforcement and related civil litigation, and FCPA enforcement.

Pete obtained his B.A., *with high honors*, from University of Notre Dame and his J.D. from The University of Virginia School of Law, where he was Order of the Coif and on the management board of the *Virginia Law Review*.

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Trading Compliance

I. SROs

A. Authority

1. The regulatory role of a national securities exchange was established in Section 6 of the Securities Exchange Act of 1934 (the "Exchange Act"), which required all existing securities exchanges to register with the SEC and to function as their own self-regulatory organization ("SRO").[1]

2. Section 19 of the Exchange Act, as amended in 1975, gives the SEC broad authority to regulate all SROs. SROs are responsible for promulgating rules that govern trading in their markets; however, the SEC retains the authority to approve or repeal SRO rules. Section 19 also charges SROs with establishing the necessary systems and procedures to enforce their rules, monitor trading, identify instances of suspicious trading, and enforce the Exchange Act. Although SROs have the authority to take final disciplinary actions against their members, SROs are required to notify the SEC of such actions. SRO final disciplinary actions are subject to review by the SEC or any other appropriate regulatory authority.[2]

3. The SEC has statutory authority to institute enforcement proceedings against SROs that fail to comply with their statutory obligations. Such enforcement actions may give rise to sanctions such as censure, suspension or in the most extreme cases, revocation of the SRO's registration.[3]

B. Jurisdiction

Section 19 of the Exchange Act specifies that SROs have jurisdiction to enforce their rules only over their members.[4] If an SRO identifies potential misconduct involving persons or entities within its jurisdiction, the SRO is responsible for investigating and, when appropriate, bringing a disciplinary action. If an SRO identifies potential misconduct involving persons or entities outside its jurisdiction, it is responsible for making referrals to the Commission or the appropriate agencies and assisting those agencies with their investigations.[5]

Although an SRO's statutory jurisdiction extends only to its members, it may seek information from nonmembers when investigating potential misconduct. In such a case, a nonmember may voluntarily submit to an SRO's authority to resolve the matter and avoid a referral to the Commission.

II. CFTC Futures Exchanges

A. The Commodity Futures Exchange Commission ("CFTC") is the agency tasked with enforcing the laws regarding market manipulation, fraud and alleged misconduct in most derivatives markets. The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") has expanded the CFTC's enforcement opportunities significantly by prohibiting manipulation and fraud in connection with "any swap, or a contract of sale of any commodity in interstate commerce, or for future delivery on or

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[1] 15 U.S.C. 78f.

[2] 15 U.S.C. 78s.

[3] 15 U.S.C. 78s(h)(1).

[4] 15 U.S.C. 78s(g).

[5] *Available at* www.sec.gov/rules/concept/34-50700.htm#IVC.

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subject to the rules of any registered entity."[6] The CFTC also obligates many of the designated contract markets ("Futures Exchanges") to enforce many of the CFTC rules and to implement many of their own rules as well.[7]

B. Many of the Futures Exchanges are owned by the Chicago Mercantile Exchange ("CME") Group. The CME Group is comprised of the CME, Chicago Board of Trade ("CBOT"), New York Mercantile Exchange ("NYMEX") and Commodity Exchange Inc. ("COMEX"), and is tasked with the regulation and enforcement of its members and market activity (of even nonmembers).

1. CME Jurisdiction

(a) Unlike SRO exchanges, anyone who initiates or executes a trade on any of the CME Group exchanges, even a nonmember, directly or through an intermediary, consents to the CME Group's jurisdiction (including any disciplinary actions brought by a CME exchange). CME Group Rule 418 specifies that:

"Any Person initiating or executing a transaction on or subject to the Rules of the Exchange directly or through an intermediary, and any Person for whose benefit such a transaction has been initiated or executed, expressly consents to the jurisdiction of the Exchange and agrees to be bound by and comply with the Rules of the Exchange in relation to such transactions, including, but not limited to, rules requiring cooperation and participation in investigatory and disciplinary processes."[8]

(b) If a party violates one of the CME Group rules, the CME Group, under Rule 402.B., has the authority to impose sanctions including:

(i) A fine of up to $5 million per violation;

(ii) Order a party to make restitution to the account of anyone damaged by the conduct; and/or

(iii) Order a party to disgorge any monetary benefit resulting from a violation, whether by that party or another party. "Benefit" includes, without limitation, profit, whether realized or unrealized, and avoided losses.

2. CFTC Oversight of Futures Exchange

Futures Exchanges, including the CME Group exchanges, are subject to oversight and periodic review of its programs by the CFTC. One of the catalysts for increased enforcement by the Futures Exchanges in recent years are these periodic reviews by the CFTC.

(a) In 2014, the CME Group was subject to a review by the CFTC of its disciplinary program for the one-year period from April 1, 2012 to March 31, 2013. As part of that review, the CFTC's Division

[6] *Available at* www.cftc.gov/LawRegulation/FederalRegister/FinalRules/2011-17549.

[7] 17 CFR § 38.150.

[8] See CME Rule 418, CBOT Rule 418 and NYMEX Rule 418 (NYMEX rules apply to COMEX). CME, CBOT, NYMEX and COMEX are independent exchanges with their own sets of rules. To provide a common regulatory framework for market users, the rulebooks have been substantially harmonized, making the rules parallel in structure, numbering and language where possible. (*Available at* www.cmegroup.com/market-regulation/rulebook.html.)

of Market Oversight critiqued the CME Group's enforcement efforts, specifically citing a shortage of enforcement staff at the CME.[9]

(b) In 2016 NYMEX and COMEX, wholly owned subsidiaries of the CME Group, were subject to a review by the CFTC of its market surveillance program for the one-year period from March 1, 2014 through March 1, 2015. The CFTC found that both exchanges have adequate market surveillance programs, including sufficient staff for the programs under review. The CFTC made only one recommendation regarding the exchanges' programs for monitoring position limit exemptions.[10]

3. Many of the rules of the Futures Exchanges involve highly technical matters, such as Exchanges for Related Position ("EFRPs"). These rules are often very specific and can present traps for the unwary. In 2015 and 2016, many of the enforcement actions (and settlements) brought by the Futures Exchanges involved EFRPs and other technical rules.

(a) Exchange for Related Positions ("EFRP") transactions allow investors to exchange futures contracts for their related physical instruments, derivative positions, options or other OTC contracts with similar characteristics.[11] In response to CFTC pressure, EFRPs have recently been the focus of regulatory actions by the Futures Exchanges.

(b) In 2016, Futures Exchanges continued to request documentation to verify that EFRP transactions were "bona fide transactions" and that any EFRP transactions entered into were in accordance with exchange rules. Understanding the various types of EFRPs, having policies in place that distinguish between permitted and impermissible EFRPs, and having effective training with trading and investment personnel are some key components to preventing EFRP infractions. Due to the highly technical nature of EFRP rules, strict liability is generally imposed on violators. It is important to note that even in instances where a fund engages in an EFRP in reliance on advice that it received from its broker (even highly regarded brokerage firms), such good faith reliance on the broker's advice will not excuse the fund in the event that the resultant transaction does not adhere strictly to the EFRP rules.

C. CFTC Enforcement.

1. In FY 2015, the CFTC brought 69 enforcement actions and collected $3.14 billion in penalties, the largest amount the CFTC has collected in its history.[12]

2. Similar to FY 2015, in FY 2016, the CFTC brought 68 enforcement actions. The CFTC also obtained orders totaling approximately $1.29 billion in restitution, disgorgement and penalties.[13]

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[9] *Available at* www.cftc.gov/idc/groups/public/@iodcms/documents/file/rernymex_comex101116.pdf.

[10] *Available at* www.cftc.gov/idc/groups/public/@iodcms/documents/file/rernymex_comex101116.pdf (The CFTC recommended that the Exchanges consider implementing a formal review process by which market surveillance staff can verify that a market participant who has a position larger than a position limit is, in fact, making use of an exemption consistent with the strategy described in their exemption application.).

[11] CME Group, Exchange for Related Positions ("EFRPs"), *available at* www.cmegroup.com/clearing/trading-practices/efp-efr-eoo-trades.html.

[12] 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.

[13] *Available at* www.cftc.gov/PressRoom/PressReleases/pr7488-16.

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III. SEF Enforcement

A. A Swap Execution Facility ("SEF") is a regulated facility, trading system or platform in which multiple participants have the ability to trade swaps by accepting bids and offers made by multiple participants in the facility. In November 2013, U.S. persons trading swaps on a "multi-to-multi" platform were required to begin trading through SEFs. In February 2014, U.S. persons were required to trade through a SEF for any made available to trade ("MAT") transaction.[14] By providing price competition that comes from trading platforms on which multiple participants have the ability to trade swaps by accepting bids and offers made by multiple participants, SEFs are intended to promote pre-trade price transparency in the swaps market.

B. SEFs are subject to SEC and CFTC regulation as a result of the Dodd-Frank Act. In 2014, the CFTC critiqued the CME Group for its enforcement program.

C. SEFs such as BSEF (a SEF operated by Bloomberg)[15] and trueEX,[16] incorporate Dodd-Frank rules into their rulebooks. Much like SROs, every SEF has its own enforcement regime. Like other SEFs, Bloomberg and trueEX's rules on jurisdiction differ from the jurisdictional rules of SROs, such as FINRA, which have jurisdiction only over their members.

1. Bloomberg SEF LLC Rule 311(a) states:

   "Any market participant that directly or indirectly effects a transaction on the SEF operated by BSEF, or any participant, authorized trader, clearing member or other person accessing or entering any RFQ or order or submitting any swap into the SEF operated by BSEF or executing any trade pursuant to the Rules (i) is bound by, and shall comply with, the BSEF rules and obligations, the clearing house rules, swap specifications and applicable law, in each case to the extent applicable to it, (ii) submits to the jurisdiction of BSEF with respect to any and all matters arising from, related to, or in connection with, the status, actions or omissions of such participant, authorized trader or other person, and (iii) agrees to assist BSEF in complying with its legal and regulatory obligations, cooperate with BSEF, the CFTC and any governmental body with jurisdiction over BSEF or the SEF operated by BSEF in any inquiry, investigation, audit, examination or proceeding."

2. trueEX LLC Rule 301 states:

   "Any person initiating or executing a transaction on or subject to the rules of the Exchange directly or through an intermediary, and any person for whose benefit such a transaction has been initiated or executed, expressly consents to the jurisdiction of the exchange and agrees to be bound by and comply with all applicable rules of the exchange to the extent applicable to it, including those applied pursuant to applicable law."

IV. Position Limits

A. Equity Options

1. U.S. options exchanges have rules regarding the maximum number of options that a single investor or a group of investors acting in concert or common control may hold. While the rules are generally

[14] Press Release, The Commodity Futures Trading Commission Staff Announces Trade Execution Mandate for Certain Interest Rate Swaps (Jan. 16, 2014), *available at* www.cftc.gov/PressRoom/PressReleases/pr6831-14.

[15] *Available at* https://data.bloomberglp.com/professional/sites/4/BSEF-Rulebook-December-15-2016.pdf.

[16] *Available at* www.trueex.com/rules-and-notices.

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directly applicable to exchange members such as a fund's brokers, and not the funds themselves, brokers may contractually obligate their customers to stay below these thresholds. Brokers may also be required to reduce any positons that they believe are above such thresholds.

2. FINRA Rule 2360 sets out applicable position limits for options.[17] The rule classifies equity options as standardized, conventional or FLEX. Standardized and FLEX equity options are exchange-traded and conventional options trade OTC.[18] FINRA Rule 2360(b)(3)(A) imposes a position limit on the number of equity options contracts in each class,[19] on the same side of the market that are held or written by a firm, a person associated with a firm, a customer or a group of customers.[20] If a person or group of persons holds an aggregate position in option contracts in excess of the allowed position limits, no broker or dealer may effect an opening transaction on behalf of that entity or group without an exemption from the applicable position limit.

3. It is important to note that position limits for standardized (exchange-traded) and conventional (OTC) options are calculated independently.

4. Position Limit Exemptions

    (a) Some strategies and options positions for standardized options render the position exempt from position limits. The same strategies and positions for conventional options increase the positon limit to five times the default limit.

    (b) Examples of strategies and positions that affect positon limits:

        (i) Back-to-back options are listed as option positions hedged on a one-for-one basis with OTC option positions on the same underlying security. The strike price of the listed option position and corresponding OTC option position must be within one strike price interval of each other and no more than one expiration month apart.

        (ii) Box spreads are long call positions accompanied by short put positions with the same strike price and short call positions accompanied by a long put position with a different strike price.

        (iii) A collar is a short call position accompanied by a long put position, where the short call expires with the long put and the strike price of the short call equals or exceeds the strike price of the long put position and where each short call and long put position is hedged with 100 shares (or other adjusted number of shares) of the underlying security or securities convertible into such underlying security. Neither side of the short call/long put position can be in-the-money at the time the position is established.

        (iv) Conversions are short call positions accompanied by long put positions where the short call expires with the long put, and the strike price of the short call and long put is equal, and where each short call and long put position is hedged with 100 shares (or other

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[17] FINRA Rule 2360(a)(21) defines an option as "any put, call, straddle or other option or privilege, which is a "security" as defined in Section 2(1) of the Securities Act, as amended, but shall not include any (A) tender offer, (B) registered warrant, (C) right, (D) convertible security or (E) any other option in respect to which the writer (seller) is the issuer of the security which may be purchased or sold upon the exercise of the option."

[18] *See* SEC, Release No. 34-70619 at 2-3, Oct. 7, 2013, *available at* www.sec.gov/rules/sro/finra/2013/34-70619.pdf.

[19] FINRA Rule 2360(a)(3) defines a "class of options" to mean all option contracts of the same type of option covering the same underlying security or index.

[20] *See* SEC, Release No. 34-70619 at 12.

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adjusted number of shares) of the underlying security or securities convertible into such underlying security.

(v) Reverse collars are long call positions accompanied by short put positions where the long call expires with the short put and the strike price of the long call equals or exceeds the short put and where each long call and short put position is hedged with 100 shares of the underlying security (or other adjusted number of shares). Neither side of the long call, short put position can be in-the-money at the time the position is established.

(vi) Reverse conversions are when a long call position accompanied by a short put position expires with the short put and the strike price of the long call and short put is equal and each long call and short put position is hedged with 100 shares (or other adjusted number of shares) of the underlying security or securities convertible into such underlying security.

(vii) Where each option contract is covered by 100 shares of the underlying security or securities convertible into the underlying security, or, in the case of an adjusted option, the same number of shares represented by the adjusted contract: (1) long call and short stock; (2) short call and long stock; (3) long put and long stock; or (4) short put and short stock.

B. Futures

1. Exchange-based trading in derivative instruments is often subject to position limit rules. Throughout 2016, U.S. futures and options exchanges continued to aggressively pursue enforcement actions against fund managers and others for position limit violations. Fines and penalties also continued to increase during the year.

2. Proposed Expansion of CFTC Position Limits

(a) The CFTC rules currently impose position limits for nine futures and commodity options contracts. Found in Part 150 of the CFTC Regulations, these “Legacy Contracts” apply to the following nine contracts: corn and mini-corn, oats, soybeans and mini-soybeans, wheat and mini-wheat, soybean oil, soybean meal, hard red spring wheat, cotton no. 2 and hard winter wheat.[21] The U.S. commodity interests position limits regime, however, is much broader than the nine Legacy Contracts, as the CFTC (in CFTC Rule 150.5) requires the Futures Exchanges, such as the CME Group Futures Exchanges and ICE Futures U.S., to implement limits on non-Legacy Contracts. The CFTC rules do specify precise limits for non-Legacy Contracts, but the CFTC has provided certain maximum limits and formulas that the Futures Exchanges must use when determining commodity interests position limits.

(b) In December 2016, the CFTC re-proposed rules that would expand the scope of the existing federal position limits regime for exchange-traded futures contracts (the “Re-Proposal”).[22] The Re-Proposal would:

(i) Establish federal limits on speculative positions in 25 core physical commodity futures contracts (instead of the current nine); and

[21] 17 CFR §§ 150 *et seq*. (2011).

[22] *Position Limits for Derivatives:* Re-proposal (Dec. 5, 2016), *available at* www.cftc.gov/idc/groups/public/@newsroom/documents/file/federalregister120516.pdf.

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(ii) Require their economically equivalent "referenced contracts" (i.e., options and swaps) to count towards such limits.

(c) It will fall to the new CFTC administration (in 2017 or later) to take any action with respect to finalizing those rules. The Re-Proposal requested comments on the possibility of delaying the compliance date of any final rule to Jan. 3, 2018, which would align the expanded CFTC position limits rules with new EU position limits rules scheduled to go into effect on that date.

3. New CFTC Aggregation Rules

(a) In 2013[23] and in 2015,[24] the CFTC proposed amendments to the CFTC Rule 150.4 aggregation rules, the rules concerning what accounts a trader must consider when determining compliance with position limits. On Dec. 5, 2016, the CFTC adopted new final rules on aggregation (the "New Aggregation Rule"). Taking into account the current and new aggregation requirements in the New Aggregation Rule, a person will now need to aggregate with their other commodity interest positions all commodity interest positions:

(i) That are deemed to be controlled by such person (e.g., makes trading decisions);

(ii) In each account in which such person has a 10-percent or greater ownership interest;

(iii) Held by a third party acting pursuant to an express or implied agreement with such person;

(iv) Held by a fund in which: (i) such person is a 25-percent or larger investor; and (ii) that is managed by a commodity pool operator that is exempt from registration pursuant to CFTC Rule 4.13; and

(v) That a person directly or indirectly (e.g., through an investment in a fund operated by an unaffiliated commodity pool operator) holds within a trading strategy that is "substantially identical" to a trading strategy overseen by such person.

(b) Aggregation Exemptions

Following the adoption of the New Aggregation Rule, there are five CFTC aggregation exemptions available to fund managers. These exemptions (other than the "fund investor" exemption) require a filing with the CFTC.[25]

(i) Three of these were preserved by the New Aggregation Rule:

(1) The "independent account controller" exemption (which would still require aggregation during the "spot month");[26]

(2) The "fund investor" exemption;[27] and

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[23] 78 Fed. Reg. 68946, Nov. 15, 2013.

[24] 80 Fed. Reg.58365, Sept. 29, 2015.

[25] The CFTC also provides aggregation exemptions not applicable to fund managers, such as exemptions for broker-dealers and FCMs. While the information-sharing exemption is discussed below, it will most likely have limited usefulness for fund managers.

[26] The independent account controller exemption permits a firm to disaggregate trading units within the same firm from each other, provided that certain conditions are met.

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(3) The "insider" fund investor exemption.[28]

(ii) While two are new:

(1) The owned-entity exemption;[29] and

(2) The information-sharing exemption.[30]

(c) It is important to note that since the position limits rules were not finalized, the New Aggregation Rules only apply to Legacy Contracts (and to other futures contracts, to the extent that the Exchanges track the CFTC rules). Should the CFTC finalize its position limits rules in the future, the Final Aggregation Rules will also be applicable to any new contracts subject to CFTC limits.

(d) Many of these aggregation exemptions will now require a filing once the rules go into effect on Feb. 14, 2017.

C. EU

1. A new position-limits and position-reporting regime will be introduced in the EU by MiFID II from January 2018. Managers should be aware that the London Metals Exchange (the "LME") has already implemented its first limit for an aluminum premium contract and may contemplate doing the same for other contracts if necessary.

2. 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.

V. Spoofing

A. In General

Spoofing typically involves a trader placing a large number of non-bona fide buy or sell orders, which the trader has no intention to complete, on one side of the market for the purpose of artificially inflating or lowering the market price of an exchange-traded financial instrument. The government's view is that non-bona fide buy or sell orders of this sort may create a false appearance of artificial buy or sell interest in the security, which may result in a price change. The trader who placed the non-bona fide orders then places bona fide orders on the opposite side of the market for the same stock, in an attempt

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[27] As a general rule, fund investors that are not affiliated with the fund manager are not required to aggregate the positions of the fund, even when above 10 percent. The one exception to that rule is a 25-percent or more investor in a fund for which the CPO relies on a Rule 4.13 exemption from registration.

[28] Another situation where a fund investor would be required to aggregate is where the fund investor is also an "insider" (e.g., a principal or affiliate of the commodity pool operator). However, these types of investors are permitted to disaggregate where certain physical and informational barriers are met.

[29] While a 10-percent or more owner is generally required to aggregate the positions of a subsidiary entity (regardless of knowledge of the positions or control), the CFTC has provided an exemption from this requirement, even for wholly-owned entities.

[30] The CFTC also provided a new exemption from aggregation in situations where the sharing of information would create a reasonable risk that either party could violate state or federal law or the law of a foreign jurisdiction, or regulations adopted thereunder (so long as one party does not have actual knowledge of the trades). To rely on this exemption, the trader must submit a memorandum of law to the CFTC supporting this conclusion. While it will not need to be a legal opinion, it should contain sufficient information to give CFTC staff the ability to discuss with the relevant regulators. While simply providing a copy of the law or legal authority would be insufficient, a memo prepared in a general matter by a law firm or trade association for a group of similarly affected persons would be sufficient, so long as it is clear from the memo how the risk affects the person.

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to take advantage of any price change resulting from the false appearance of buy or sell interest. Once the market moves, the trader quickly cancels his open orders to take advantage of the artificially high or low price with orders on the opposite side of the market.

B. Prohibition of Spoofing

1. Securities statutes do not prohibit spoofing by name but do outlaw market manipulation. The U.S. Supreme Court has explained that market manipulation refers generally to practices that are intended to mislead investors by artificially affecting market activity and "connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities."[31] The SEC and FINRA have both been active in pursuing spoofing cases as types of alleged market manipulation.

2. Dodd-Frank amended Section 6c(a) of the Commodity Exchange Act to make "spoofing" in the commodity futures markets a violation of federal law. The anti-spoofing provision states that it is, "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)."

   In 2013 the CFTC released an interpretive guidance on what it considers spoofing. Significantly, the CFTC's guidance recognizes that intent is an essential element of any spoofing claim. As such, the CFTC does not interpret "reckless trading, practices, or conduct as constituting a 'spoofing' violation." Moreover, the CFTC stated that, "orders, modifications, or cancellations" submitted as part of a "legitimate, good-faith attempt to consummate a trade" would not be considered "spoofing."[32]

3. CME Rule 575 also prohibits spoofing. That rule specifies:

   (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. Enforcement and Criminal Prosecutions Concerning Spoofing.

1. *United States v. Coscia*, No. 14-cr-00551 (N.D. Ill. Nov. 3, 2015). This was the first-ever criminal charge and conviction for spoofing. Michael Coscia, a high-frequency trader, was charged by the DOJ and convicted on six counts of market manipulation and six counts of spoofing for manipulating commodity futures contract markets on various CME Group Markets and ICE Futures Europe, a futures exchange based in London. Although those transactions generated only $1,070 of profits, prosecutors felt the matter was significant enough to warrant indictment and trial.

2. Following his criminal conviction, Coscia appealed to the U.S. Court of Appeals for the Seventh Circuit. Although the court has not yet issued an opinion, the oral argument before the court produced some interesting exchanges between counsel and the judges who will decide the appeal.

[31] *Ernst & Ernst v Hochfelder*, 425 US 185, 199 (1976).

[32] *Available at* www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2013-12365a.pdf.

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(a) Coscia's counsel argued that the statute is unconstitutionally vague because it does not adequately define the conduct that constitutes the crime of spoofing and thereby failed to give him notice of what actions were prohibited. His counsel also noted that the relevant provision of law did not define spoofing and prior to the time of Coscia's alleged wrong conduct, the CFTC provided no guidance on prohibited spoofing.

(b) Some of the court's questions indicated skepticism about the ability to distinguish between legitimate and illegitimate orders in an industry where computerized algorithms place and cancel offers in milliseconds. A main focus of the oral arguments was on the algorithm Coscia used and the difference between contingent orders and orders that constituted spoofing. Contingent orders, such as stop-loss orders, seem to fit the statutory definition of spoofing yet no one would consider those illegal. When a trader places a stop-loss order, he does not intend the order to be executed, because presumably that would mean the market is trending in a direction opposite his expectation, but would accept an execution if the conditions of the stop-loss order were realized.

3. On Dec. 20, 2016, the U.S. District Court for the Northern District of Illinois approved a settlement between the CFTC and defendants Igor B. Oystacher and his firm, 3Red Trading LLC, who were accused of engaging in "a manipulative and deceptive spoofing scheme while trading at least five different futures contracts on four exchanges for more than two years."[33] Under the terms of the settlement, Oystacher and 3Red agreed to pay a $2.5-million penalty and have all their futures trades be overseen by an independent monitor for the next three years. Oystacher and 3Red are also required to employ certain compliance tools with respect to futures trading on U.S. exchanges for a period of 18 months.

VI. Systematic Trading Considerations

A. Wash-trades

Managers (particularly quantitative and systematic managers) should consider examining their wash-trading and cross-trading policies, procedures and surveillance methods to ensure that inadvertent wash- or cross-trading is not occurring in violation of exchange rules or federal regulations. Managers with ERISA accounts have to be particularly cognizant of this issue.

B. Tag 50s

The CME released additional guidance in 2016 on the use of Tag 50 IDs in the Globex environment. Managers should determine if they are appropriately employing enough Tag 50 IDs; under the current CME guidance, many automated trading strategies will require a manager to obtain multiple "team" or even "individual" Tag 50 IDs.

VII. Miscellaneous Issues in Trading Compliance

A. Rule 105 of Regulation M[34]

[33] *Available at* www.cftc.gov/PressRoom/PressReleases/pr7504-16.

[34] 17 CFR § 242.105.

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1. In General

Rule 105 makes it unlawful for any person to purchase equity securities in a firm commitment equity offering from an underwriter or broker-dealer participating in the offering if that person shorted the security that is the subject of the offering during the Rule 105 restricted period, absent an available exception.

(a) Firm commitment underwritten offering: 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.

(b) 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.

2. The Rule 105 Restricted Period[35]

(a) The restricted period is the shorter of the period: (i) five business days before the pricing of the offered securities through the day of pricing; and (ii) the day of initial filing of the registration statement through the day of pricing.

(b) Calculating the Five Business Days:

(i) A "business day" refers to a 24-hour period determined with reference to the principal market for the securities to be distributed, including 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 (assuming no intervening holidays and that the market was open on each of those days) and end at pricing on the following Thursday.

(iii) Common Pitfall

(1) In calculating the restricted period, mistakes in the calculation are common when holidays come into play. 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.

(2) Using the example above, if pricing occurs on a Thursday after the principal market closes but Monday was a holiday (and the principal market was closed that day) then the restricted period would begin at the close of trading on the Wednesday of the previous week.

(c) Calculating the Day of Initial Filing of the Registration Statement:

(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 well-known seasoned issuers ("WKSIs")

[35] 17 CFR § 242.105(a).

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(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) Common Pitfall

Oftentimes, a prospectus supplement containing the specific information with respect to the offering is filed right before the offering. This is not the initial registration statement.

3. The Bona Fide Purchase Exception to Rule 105[36]

(a) The bona fide purchase exception permits a person who established a short position in the offered security during the restricted period to purchase in the offering if the person covered the short position prior to the pricing of the offering by entering into a bona fide purchase of the security. In order to qualify for the exception, the pre-pricing covering purchase must be:

(i) For a quantity at least equal to the amount of the pre-pricing period short sales;

(ii) Effected during regular trading hours;

(iii) Reported pursuant to an effective transaction reporting plan; and

(iv) Effected at least one business day prior to the pricing of the offering. If the bona fide purchase is made on the business day prior to pricing (the last permissible day), the purchase must occur before the final 30 minutes of regular trading hours.[37]

(b) Common Pitfall

The first criteria to come within the exemption requires a person to purchase, after its last restricted-period short sale, at least as many subject securities as it has shorted during the entire restricted period. No credit is given for covering purchases that occurred between restricted-period short sales. For example, if during the Rule 105 restricted period a firm sold short 15,000 shares of XYZ security on Oct. 1, covered 5,000 shares of XYZ on Oct. 2 and sold short 10,000 shares of XYZ on Oct. 3, the firm would need to cover 25,000 shares following its Oct. 3 short sale to qualify for the exception. The 5,000 share cover on Oct. 3 is not considered for purposes of the exception because it took place before the last of the restricted-period short sales.

4. Separate Accounts Exceptions[38]

(a) Under the separate accounts exception, Rule 105 does not prohibit a person from purchasing the offered securities if the person sold short during the Rule 105 restricted period in a separate account. Separate accounts are those that operate without coordination of trading or cooperation. Indications of separate accounts include:

(i) Separate and distinct investment and trading strategies and objectives;

[36] 17 CFR § 242.105(b)(1).

[37] *Available at* www.sec.gov/divisions/marketreg/tmcompliance/regmrule105-secg.htm.

[38] 17 CFR § 242.105(b)(2).

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(ii) Personnel for each account that do not coordinate trading among or between the accounts;

(iii) Information barriers in place so investment decisions are not shared between accounts;

(iv) Separate profit and loss statements;

(v) No allocation of securities between or among accounts; and

(vi) Persons with oversight over the accounts who do not have authority to execute trades or pre-approve trading decisions.[39]

(b) The SEC has denied the "separate accounts" exception, even though there were two separate accounts with different strategies and portfolio managers, where information about securities positions and investment decisions was available to all of the firm's employees and sometimes communicated between strategies, the chief investment officer exercised oversight over the firm's multiple strategies and influenced trading decisions within the strategies, and the firm did not prohibit its personnel from coordinating trading between or among strategies.[40]

5. Rule 105 Liability

(a) Rule 105 is not intended to catch only systematic "scams" — even a single violation can lead to charges. Charges can be brought for even trivial amounts, but penalties can constitute a significant percentage of the overall disgorgement. 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.[41]

(b) Virtually all the settlements of Rule 105 cases describe the violations of the rule as "willful." It is important to note that "willful" in the context of Rule 105 does not mean the rule was intentionally violated but that "the person charged with the duty knows what he is doing."[42] There is also no requirement that the actor "also be aware that he is violating one of the Rules or Acts."[43] What this means is that the actor who made the trade knew that he was making a trade and that the trade constituted the violation (even if the actor did not know that the trade constituted a violation at the time he made the trade). In other words, because Rule 105 does not require proof of scienter, whether the person knew the conduct violated any securities law or rule is irrelevant.

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[39] *Available at* www.sec.gov/divisions/marketreg/tmcompliance/regmrule105-secg.htm.

[40] *Available at* www.srz.com/images/content/5/7/v2/57894/IMHT-051211-Booklet-Website.pdf.

[41] *Available at* www.srz.com/images/content/5/7/v2/57894/IMHT-051211-Booklet-Website.pdf.

[42] *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949).

[43] *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)).

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Challenges Terminating Old Funds and Launching New Ones

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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 (including LBO, mezzanine, distressed, real estate and venture) and liquid-securities funds (including hedge funds and hybrid funds), as well as providing regulatory advice to investment managers. 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 serving as 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 former member of the board of directors and current member of 100 Women in Finance, 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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Brad focuses his practice on counseling hedge 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 startups, 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 recently presented on market terms and regulatory issues for co-investments, regulatory changes to Form ADV and recordkeeping requirements, as well as other compliance topics for private investment funds. He also contributed to *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and co-authored "New Form ADV: The Impact on Private Fund Advisers" and "The New AML Rules: Implications for Private Fund Managers," which were published in *The Hedge Fund Journal*.

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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, as well as tax issues prospective investors face with such investments; tax considerations related to employee and executive compensation, including deferred compensation programs; and partnership taxation.

Recognized by *The Legal 500 United States* as a leading tax lawyer, David has spoken on tax issues related to running investment management firms and their funds, as well as hedge fund tax considerations and compensation structures. He contributed to "Hedge Fund Employee Compensation," published by *Practical Law*, and *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press). David recently presented "Hedge Funds" at PLI's Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances conference. He is a member of the American Bar Association and the New York State Bar Association.

David holds an LL.M. in taxation and a J.D., *magna cum laude*, from New York University School of Law, where he was a Florence Allen Scholar and Order of the Coif, and an A.B., *cum laude*, from Harvard University.

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Chris is the co-head of Schulte Roth & Zabel's London office, of which he was one of the two founding partners in 2002. He has over 20 years of experience advising on the launch and operation of many of the highest profile hedge funds, having been active since the earliest days of the European hedge fund industry. He advises a wide range of both institutional and entrepreneurial investment managers, other financial services firms and investment funds of all types, especially hedge funds, hybrid funds, co-investment funds and distressed funds. He advises investment manager clients located in the United Kingdom, France, Switzerland, Malta and other European countries, as well as the United States, Sub-Saharan Africa and Asia. He provides legal and business advice on the structuring and operation of funds, including fundraising, investor issues, investment transactions and prime brokerage agreements. He has advised on a large number of seed and strategic investments as well as spinoffs of investment teams from banks and existing investment managers. His practice also includes advising clients on regulatory and compliance matters and finding practical solutions to the many issues clients face on a day-to-day basis.

Chris has been described by interviewees in *Chambers UK* as "fantastic — practical, commercial and knows his stuff" and as a "go to lawyer for dealing with a complicated hedge fund" and in *The Legal 500 United Kingdom* as "excellent" and "knows the industry inside out." He was one of only two hedge fund lawyers listed as a leading individual by *The Legal 500 United Kingdom* in 2015, which also included him as an elite leading lawyer in investment funds in 2014. One interviewee is noted as saying "if he tells you something, you're extremely confident that you're getting the best practical commercial advice." Chris has also been named as a leading funds lawyer in *Chambers UK*, *Chambers Europe*, *Chambers Global*, *The Expert Guide to the Best of the Best* (which named him as one of the top 25 funds lawyers worldwide), *Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers*, *IFLR1000*, *PLC Cross-Border Investment Funds Handbook*, *Who's Who Legal: The International Who's Who of Private Funds Lawyers* and *Who's Who of Professionals*. Chris was invited to participate in the UK Financial Services Authority's Legal Experts Group in respect of AIFMD and has been an active participant on various AIMA and other industry committees on matters relating to the hedge fund industry. He is a frequent speaker at industry conferences and seminars, including invitation-only conferences for clients of prime brokers and other industry participants. He has also written widely on a wide range of hedge fund and regulatory topics. Chris recently co-authored "Brexit: What Alternative Asset Managers Can Expect," published in *The Hedge Fund Journal*, as well as authored a chapter on "Conflicts of Interest" in *Investment Management, Law and Practice*, published by Oxford University Press, and co-authored a chapter on "United Kingdom Considerations" in *Hedge Funds: Formation, Operation and Regulation*, published by ALM Law Journal Press.

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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.

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

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Challenges Terminating Old Funds and Launching New Ones

I. Terminating Old Funds

A. Decision-making and Planning Ahead

An investment manager may choose to terminate a fund for various reasons. For example, the term of the fund may have come to an end, investors may have submitted significant redemption requests, a portfolio manager may be retiring or changing firms, or the manager may want to focus on a different or new strategy. Regardless of the reason for terminating a fund, an investment manager should consider its fiduciary duties to its clients, as well as the importance of maintaining its business and reputation before making a decision to terminate a fund. Once an investment manager determines that terminating a fund is in the best interests (or at least not unreasonably adverse) to the investors and advisable for its business, it should develop a comprehensive plan to deal with the fund's portfolio, investors, counterparties and service providers and to address employees. An investment manager should seek to ensure that its plan to terminate the fund is fair to its investors and other third parties to preserve the manager's reputation and enable the manager to transition its business successfully.

B. Addressing Investors

One of the most important aspects of a manager's plan to terminate a fund is communicating with investors. An investment manager should clearly communicate (but not overpromise) the plan of termination (including the timing of cash distributions and disposition of less liquid assets) to its investors. Clearly communicating a well-developed plan to investors should help reduce investor concerns or complaints.

1. Retaining Investors: An investment manager may attempt to explain the reasons for termination of a fund in positive terms (e.g., the manager's plan of termination will allow the investors to receive value for remaining investments and avoid increasing expense loads) and provide sufficient detail to investors (e.g., expected timing of liquidation) to seek to prevent investor concern, maintain a good business reputation and encourage interest in future funds of the manager. It is critical from an investor relations and business perspective for a manager to be proactive in talking to investors about the manager's plan going forward. A manager that may want be launching new funds may want to give investors the option to invest (and/or roll-over proceeds) to its new products.

2. Fiduciary Duties: An investment manager has a fiduciary duty to its investors and should not provide material selective disclosures that benefit certain investors. In the context of the termination of a fund, an investment manager should be careful to provide full and fair disclosures to all investors in the fund on a timely basis. In particular, a manager should be mindful not to disclose its plan to terminate the fund only to select investors immediately preceding a notice deadline for a redemption date. Consideration should also be given to the effect that news of the wind-down will have on the fund's portfolio; if possible, thinly traded and less liquid investments should be sold, and short positions unwound, before termination plans are announced. Additionally, in the event that a fund has received significant withdrawal requests, but is not yet in wind-down mode, the manager should consider notifying all of its investors to the extent the withdrawals may impact the continued viability of the fund.

3. Contractual Duties: An investment manager must also comply with all contractual duties due to its investors that are triggered upon a determination to terminate a fund. An investment manager should review the governing documents of the fund and side letters with investors and provide

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investors the relevant notices or take other steps as required by the relevant terms of such agreements.

4. Offshore vs. Onshore: How a manager deals with the investors in a fund in the process of dissolving and winding down such fund will differ depending on the jurisdiction in which the fund is organized. With respect to Cayman Islands funds, an investment manager will typically compulsorily redeem investors prior to termination of the fund (otherwise the manager may be required to appoint a liquidator).

C. Disposing Assets

When terminating a fund, one of an investment manager's primary responsibilities is to think through the best way to dispose of the securities or other assets held by the fund and satisfy the fund's liabilities. As a fiduciary to the fund, an investment manager should consider what is in the best interests of the fund and its investors as a whole. An investment manager has several options for how it can deal with the assets of a fund that is to be terminated, and it should consider maximizing value for investors, timing, tax considerations, contractual or regulatory obligations and investor expectations.

1. Suspension of Redemptions or Withdrawals: For most private investment funds, the board of directors of the offshore fund or general partner of the domestic fund may suspend redemptions or withdrawals to provide stability during the wind-down process. However, extended periods of suspension could raise fiduciary issues and concerns from investors ("zombie funds").

2. Cayman Islands Loss of Substratum: Timing of disposing assets is particularly critical with respect to funds organized in the Cayman Islands. Under Cayman Islands law, if a fund loses its "substratum," which means the fund's business purpose can no longer be carried out and potentially may be evidenced by an indefinite suspension of redemptions due to a prolonged liquidation process, an investor may be entitled to a winding-up order and the appointment of a liquidator, in lieu of an informal liquidation process supervised by the investment manager.

3. Custody Rule: A registered investment adviser must also comply with Rule 206 (4)-2 (the "Custody Rule") and, if applicable, conduct a final liquidation audit of the fund (see further discussions below under "Regulatory Considerations — Custody Rule"). Compliance with the Custody Rule is another consideration regarding the timing of disposing assets and making distributions, as a manager may wish to complete the liquidation of the fund on or before year-end to avoid another tax year.

4. Options for Disposing Assets

    (a) Open Market or Private Sale: When selling fund assets in the open market or in a private transaction (depending on whether it is a public or private security), an investment manager should consider the timing and price of sale, in light of investors' expectations to receive cash distributions in a timely manner while also receiving fair value for the sale of the assets from the portfolio.

    (b) In-kind Distributions: In lieu of cash, an investment manager may distribute in-kind securities to investors in a fund. Whether an investment manager is allowed to distribute in kind will depend on the governing documents of the fund and any side letter agreements with particular investors. In-kind distributions may be effected by distributing a "vertical slice" of the portfolio to each investor consisting of a pro rata portion of each remaining security in the fund. In-kind distributions raise several challenging issues, including valuation and operational issues, relating to the transfer to investors.

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(c) Secondary Sales: The interests of existing investors may be sold to new investors in the secondary market. Secondary sales raise valuation issues, particularly with respect to private or illiquid securities. Tax considerations for the fund and its investors, especially for funds that are treated as partnerships for U.S. tax purposes, need to be analyzed before proceeding with such transactions.

(d) Manager Buyout: An investment manager may choose to buy the interests of the investors in a fund or to buy the remaining assets and/or liabilities. Purchase of assets of a fund is a principal transaction. Accordingly, the investment manager should notify the investors in writing and obtain appropriate consent before the completion of the manager buy-out in accordance with Section 206(3) of the Investment Advisers Act of 1940, as amended (the "Advisers Act"). Additionally, the investment manager should also make sure that any valuation in connection with a principal transaction is in accordance with its valuation policy, and many investment managers seek an independent valuation of the securities from independent third parties in these situations. Purchase of interests from investors avoids these issues since each investor consents to its own sale. However, this may not achieve the desired goal of terminating the interests of all outside investors. Also, the manager will have fiduciary duties to give investors accurate information to assist in their sale decision.

(e) Moving Assets to Other Funds or Merging Funds: The assets of a fund that is winding down may be moved to a new successor fund or to an existing fund or funds that are being consolidated with the fund that is winding down. *See* further discussion on transferring assets (including tax considerations) below in connection with launching new funds.

(f) Liquidating Trust/Escrow Account: A manager may choose to transfer the remaining securities of a fund to a liquidating trust or an escrow account. In such case, a manager may argue that it does not have custody over the securities of such liquidating trust or escrow account and, therefore, is no longer obligated to comply with the custody rule with respect to such liquidating trust or escrow account. However, as discussed further below, this analysis depends on whether the manager will continue to "advise" with respect to securities in the liquidating trust or escrow account.

D. Dealing with Counterparties, Vendors, Service Providers and Other Third Parties

To terminate a fund, an investment manager should: (i) identify all outstanding agreements (operational, administration, trading) and any outstanding or potential obligations; (ii) review and terminate, as necessary, contracts with trading counterparties, vendors and service providers; and (iii) request final invoices to be submitted. The relevant counterparties, vendors and service provides may include seed capital providers, administrators, prime brokers, trading counterparties, vendors, financing sources, auditors, attorneys and other creditors. Working closely with the directors of the offshore funds is critically important and will be one of the first steps in terminating a fund. The directors of the offshore fund will be involved in every step of the process.

1. NAV Triggers: With respect to trading counterparties, there may be potential obligations triggered by NAV reductions during the wind-down of a fund. To the extent a manager needs to keep the contract alive with such a counterparty, the manager may need to seek waivers of such NAV triggers.

2. Going Concern: An auditor may include a going-concern note in a fund's financials, which could trigger potential obligations under agreements with other counterparties or service providers (e.g., credit agreement, ISDA master agreement). A manager, therefore, should ensure that it provides

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timely and sufficient disclosures regarding the termination (or plan for termination) of a fund to the auditors so that they are in sync with the manager in their preparations of such fund's financials.

3. Zone of Insolvency: When a fund is solvent, the investment manager's fiduciary duties are to the fund and its investors (e.g., equity owners). However, when a fund enters into the zone or vicinity of insolvency, the manager may owe fiduciary duties to the creditors of the funds.

E. Dealing with the Investment Manager's Personnel

An investment manager should think through the best way to deal with its employees and to retain and incentivize key personnel (or dismiss others). An investment manager should carefully consider whom to tell and when, as well as the impact to the manager's business.

1. Obligations to Employees: The manager will need to review contracts with personnel and meet any obligations due to such personnel in accordance with the relevant contracts (employment agreements, profit-sharing agreements and guarantees, severance payments, etc.).

2. Retaining Key Personnel

    (a) A manager may want to retain certain key personnel during the process of winding down and terminating a fund. For example, a manager may want to keep those portfolio managers with knowledge of the assets of the fund that is winding down so that they can assist in disposing the assets in a way that will maximize the value for investors. The manager will also need a financial officer to complete financial reporting and legal personnel to handle legal/compliance obligations until a fund is actually terminated.

    (b) A manager also may want to retain key personnel for purposes of launching and advising future funds or hire new personnel. A manager may provide additional benefits in the employment contracts or reconsider its management company structure for purposes of retaining or acquiring talent for their new funds.

F. Technical Requirements

1. An investment manager will need to comply with various technical requirements before formally terminating a fund.

2. Under Section 17-203(a) of the Delaware Revised Uniform Limited Partnership Act (the "RULPA"), a fund may only be terminated "upon the dissolution and the completion of winding up of the limited partnership." Therefore, before terminating a fund, an investment manager needs to confirm that there is no pending litigation, indemnities and/or liabilities of the fund. The manager may circulate a list of securities previously held by the fund to: (i) internal valuation, accounting, legal and investment professionals; and/or (ii) outside law firms (fund counsel, as well as deal and/or litigation counsel) and request confirmation of the existence of any litigation or other existing or potential liabilities.

3. If the fund has been notified for marketing in an EU jurisdiction, then notice of termination should be given to the relevant regulatory authorities.

4. Once final invoices are submitted and any outstanding or potential obligations identified, the investment manager should: (i) pay the fund's creditors; (ii) pay any termination expenses; (iii)

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establish reserves to cover any ongoing liabilities; and (iv) distribute its assets to the remaining investors.[1]

5. Tax Forms and Reporting

    (a) For a fund that is treated as a partnership for U.S. federal income tax purposes, the fund must:

        (1) Prepare and file a final annual return with the IRS, due on the 15th day of the third month following the fund's termination; and

        (2) Provide final capital account balance statements, tax forms and K-1s to all partners or members of the fund that is winding down.

    (b) A non-U.S. fund should cancel its FATCA registration with the IRS and any related registration(s) in the fund's jurisdiction of residence.

6. Final Notices and Filings

    (a) An investment manager should prepare resolutions of the general partner or board of directors of a fund approving the wind-down of the fund and provide final notice of termination to the fund investors.

    (b) For onshore funds, the investment manager needs to file a Certificate of Cancellation (or its equivalent) of the fund with the state of formation and the state(s) in which the fund is authorized to do business.

G. Deferred Fees

1. If the fund has an existing deferred fee arrangement with the investment manager, the termination of the fund is usually an event that would accelerate payment to the investment manager. Careful consideration must be given to when related payments may be made to the investment manager so as not to run afoul of U.S. tax rules regarding nonqualified deferred compensation.

2. In addition, an investment manager should consider both its fiduciary duties and investor relations when determining when and how it will or must pay deferrals upon dissolution of the fund.

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[1] Section 17-804 of the RULPA provides:

(a) Upon the winding-up of a limited partnership, the assets shall be distributed as follows:

(1) To creditors, including partners who are creditors, to the extent otherwise permitted by law, in satisfaction of liabilities of the limited partnership (whether by payment or the making of reasonable provision for payment thereof) other than liabilities for which reasonable provision for payment has been made and liabilities for distributions to partners and former partners under § 17-601 or § 17-604 of this title;

(2) Unless otherwise provided in the partnership agreement, to partners and former partners in satisfaction of liabilities for distributions under § 17-601 or § 17-604 of this title; and

(3) Unless otherwise provided in the partnership agreement, to partners first for the return of their contributions and second respecting their partnership interests, in the proportions in which the partners share in distributions.

(b) A limited partnership which has dissolved:

(1) Shall pay or make reasonable provision to pay all claims and obligations, including all contingent, conditional or unmatured contractual claims, known to the limited partnership;

(2) Shall make such provision as will be reasonably likely to be sufficient to provide compensation for any claim against the limited partnership which is the subject of a pending action, suit or proceeding to which the limited partnership is a party; and

(3) Shall make such provision as will be reasonably likely to be sufficient to provide compensation for claims that have not been made known to the limited partnership or that have not arisen but that, based on facts known to the limited partnership, are likely to arise or to become known to the limited partnership within 10 years after the date of dissolution.

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H. Regulatory Considerations

1. Books and Records: Even for a fund that has been terminated, a manager must keep required books and records for five years from the end of the fiscal year during which the record was created to comply with the recordkeeping rules of Rule 204-2 under the Advisers Act.

2. Custody Rule

    (a) The Custody Rule is a long-standing Advisers Act rule affecting registered investment advisers that have, or that are deemed to have, "custody" of client funds and securities. The rule sets forth a number of requirements intended to safeguard client funds and securities from an adviser's misappropriation and to insulate client assets from an adviser's insolvency.

    (b) Under Rule 206(4)-2 (the "Custody Rule"), a registered investment adviser is deemed to have custody of client assets if the adviser or a "related person" of the adviser holds, directly or indirectly, client funds or securities or has any authority to obtain possession of them. While an investment adviser generally does not directly hold client funds or securities, usually relying on prime brokers, banks and other custodians instead, an adviser is often deemed to have custody because: (i) it is party to an arrangement (such as an investment management agreement) under which it has the authority to withdraw funds or securities from a client account (either as a general matter or to satisfy a management or performance fee payment obligation); or (ii) the adviser or a related person serves in a capacity, such as a general partner, managing member or trustee, that gives it or its supervised persons legal ownership of or access to client funds or securities.

    (c) In the private fund context, the Custody Rule's key safeguarding requirements are as follows: (i) maintenance of client funds and securities with a qualified custodian; (ii) the "pooled vehicle annual audit exception"; and (iii) requirements for client accounts that cannot rely on the audit exception.

    (d) Advisers utilizing the pooled vehicle annual audit exception and winding up a pooled investment vehicle must ensure that they obtain a final audit upon liquidation of that vehicle. While the SEC has not provided guidance on the definition of "upon liquidation," best practice in this area is generally to provide for the final audit to be performed after all amounts have been distributed to investors and no other assets remain in the vehicle.

    (e) To the extent the vehicle has remaining securities, contingent liabilities or cash, it cannot liquidate and the adviser generally must continue conducting annual audits. Many investment advisers seek to stop conducting annual audits to reduce ongoing expenses for investors. Some investment advisers consider moving all remaining securities and assets of the fund to a liquidating trust or escrow account. Other investment advisers consider structures using contract notes or participations and liquidating the fund. However, it is not clear that all such structures will allow a registered investment adviser to cease conducting annual audits of the fund under the Custody Rule. The analysis will depend on the specific facts and circumstances and the adviser will likely need to continue conducting annual audits unless the adviser is no longer providing investment advice or acting as an investment adviser (defined broadly) to the liquidating trust, account or other structure. Generally, an adviser should cede any ongoing investment role with respect to the liquidating trust or account, and underlying securities and assets, and the remaining assets should be distributed according to a mechanical formula and the process administered by an independent party (such as an independent escrow agent or trustee). There is also no stated exception for vehicles with a small number of investors, assets

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or cash, or for vehicles where the costs of the liquidation audit are disproportionate to the fund's assets.

3. Investment Adviser Registration

   (a) Terminating funds may cause a small- or mid-sized adviser's regulatory assets under management ("Regulatory AUM") to fall below the eligibility threshold for registration under the Advisers Act and require the adviser to withdraw its registration. There is a grace period as the adviser will only need to withdraw when it no longer can reaffirm its eligibility to be registered in its Annual Updating Amendment to the Form ADV, which is due within 90 days after the adviser's fiscal year-end. Some advisers may be eligible for the private fund adviser exemption from registration and need to switch to an Exempt Reporting Adviser filing. Other advisers may consider the narrow "family office exemption" as an option to continue the business and create a track record (without being subject to registration with the SEC) by managing the assets of the manager and his/her family members.

   (b) Withdrawing from registration as an SEC-registered investment adviser is governed by Section 203(h) of the Advisers Act. Rule 203-2 under the Advisers Act specifies that an investment adviser must file a Form ADV-W to withdraw from registration with the SEC, and that there is no fee for such filing. Form ADV-W requires information about, among other things, the status of the investment adviser's business, the reason for the withdrawal, the custody of its clients' assets, money owed to clients, the assignments of any advisory contract, the investment adviser's financial condition and the status of its books and records.

   (c) If the adviser withdraws its SEC registration, the adviser will also need to consider whether it is required to register with the applicable state securities authority.

4. Regulatory Filings: Form ADV, Form PF and Section 13 Filings

   (a) An adviser that has sufficient Regulatory AUM to be eligible to continue its registration with the SEC after terminating a fund will nevertheless be required to update its Form ADV filing. Depending upon the specific facts and circumstances, an "other than annual amendment" may be required to be filed promptly or the adviser may be permitted to disclose such termination in its Form ADV Part 1A annual amendment.

   (b) An adviser may also file a final Form PF filing if: (i) it is no longer registered with the SEC; and/or (ii) it no longer has at least $150 million of Regulatory AUM.

   (c) Depending on the securities that an adviser continues to manage upon liquidating a fund, such liquidation may impact the adviser's Section 13 filings, such as Forms 13F, 13D and 13G.

5. ERISA Concerns

   An investment adviser may not want the assets of a fund to be treated as "plan assets" for purposes of the U.S. Employee Retirement Income Security Act of 1974, as amended ("ERISA"), when such fund is winding down. In such case, the adviser should make sure that the investors that are "benefit plan investors," as defined in Section 3(42) of ERISA, hold less than 25 percent (or such greater percentage as may be specified in regulations promulgated by the U.S. Department of Labor) of the value of each class of equity interests in the fund during the wind-down process (including when distributing assets or redeeming investors).

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II. Launching New Funds

A. Strategy of New Funds

An investment manager may launch new funds with similar or different strategies from the fund it is terminating. Some investment managers may use the legal structure of a fund and change its strategy instead, but most will create new legal structures.

1. The strategy of a new fund will depend on the situation (e.g., the level of success of the prior fund, market changes), and an investment manager should carefully craft its disclosure of the new fund strategy to highlight improvements while ensuring it is not making any false or misleading statements or omitting material facts.

2. In addition to launching a new fund, an investment manager may want to keep a prior fund nominally alive by managing internal capital to have continuity of its track record. However, keeping a fund nominally alive may not achieve the intended results as performance may differ with limited capital and without key personnel. In addition, investors may not view the performance of a smaller internal fund in the same manner as larger funds managed for third parties.

3. Variations of Strategies for New Funds

    (a) Levered Version: The new fund may use more leverage than a prior fund to seek higher returns (with higher volatility).

    (b) Multi-strategy: A new fund may combine the strategies of and purchase remaining assets from liquidating funds.

    (c) Concentrated/Customized: The new fund may be a customized or concentrated subset of a liquidating fund's strategies. Examples of concentrated/customized products include:

        (i) Concentration by security type (e.g., long-only funds, exposure to equities but not fixed income);

        (ii) Concentration by conviction level (sometimes referred to in the industry as a "best ideas" fund);

        (iii) Selective exposure only to specific portfolio managers (for managers that internally allocate capital to multiple portfolio managers);

        (iv) Concentration by business sector (e.g., only health care or media); and

        (v) Concentration by geographic regions (e.g., an Asia-only fund).

    (d) New Strategies: An investment manager may bring in new personnel and offer products with new strategies.

B. Legacy Assets

A new fund may acquire assets from a fund that is winding down.

1. Segregation of Assets: Assets and liabilities that are acquired from liquidating funds may be segregated from the other assets of the new fund and maintained for certain investors in a special

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class (e.g., the investors who were originally in the fund that is winding down). Additionally, if an investment manager is keeping the legal structure of a fund, but changing its strategy, it may segregate the assets from the old strategy into a new, separate class of the existing fund. Managers should note that without a "series" structure, separate classes will be subject to cross-class liability.

2. Fiduciary Duties: Transferring assets from a liquidating fund to a new fund is a cross-trade (and possibly a principal transaction depending on the level of proprietary ownership). Before engaging in a cross-trade, the manager, as fiduciary to both funds, should determine that the trade is in the best interests of both funds and take steps to ensure that the transaction is consistent with the duty to obtain best execution for each fund. Additionally, if a cross-transaction between two funds occurs by having the manager instruct the custodian for the funds to book the transaction at the price determined by the manager's valuation procedures, the manager may not receive any fee in connection with the completion of the transaction. Finally, as a fiduciary, a manager should provide sufficient disclosure regarding any legacy assets to investors in the fund acquiring the assets.

3. Tax Consequences of a Transfer of Non-cash Assets to a Fund Taxed As a Partnership for U.S. Tax Purposes

   (a) To the extent an investment manager contributes assets from one fund (e.g., a fund that is winding down) to another (e.g., a new fund being launched by the same manager), under Section 721(b) of the Internal Revenue Code of 1986, as amended, the transfer may result in the contributor recognizing gain, but not loss, on the contribution if the contribution results in a "diversification" of the transferor's assets.[2]

   (b) Under Treasury Regulations Section 1.351-1(c), if the contributed assets constitute a portfolio of stocks and securities which is already "diversified," the contribution would not result in recognition of taxable gain so long as each person contributing noncash assets contributes a "diversified" securities portfolio and there is no plan for the partnership to have a subsequent non-diversified in-kind contribution. If one person contributes a non-diversified portfolio, all contributors (including another investment fund that is contributing its portfolio to the target partnership) may be required to recognize taxable gain (but not recognize taxable loss) with respect to their portfolio contributions.

   (c) A diversified portfolio of stocks and securities generally exists if:

      (i) The stock or securities of any one issuer do not constitute more than 25 percent of the gross asset value of the noncash assets being contributed; and

      (ii) The stock and securities of five or fewer issuers do not constitute more than 50 percent of the gross asset value of the noncash assets being contributed.

C. Inherited Fund Terms

To the extent investors from a liquidating fund are investing in a new fund managed by the same investment manager, the new fund may carry over some of the terms of the liquidating fund for those investors. Specifically, continuing investors may be offered or request:

1. To carry over their high water mark from the terminated fund;

[2] These tax consequences may not apply to certain non-securities partnerships, such as certain real estate funds.

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2. Fee breaks (either based on their commitments to the new fund or based on their commitments to the new fund and any other funds of the manager in which such investors had invested or are investing);

3. Carryover of side letter terms, including an MFN based on both their commitments to the new fund and any prior funds (to incentivize loyalty); and/or

4. Other rights and privileges to the extent that they had such rights and privileges in connection with the terminated fund of the manager.

D. New Fund Terms

An investment manager should consider if there are terms from a prior fund that they want to change. Additionally, an investment manager should consider current market terms and whether to include those terms in the new fund.

E. Use of Track Record

1. To the extent the new fund's strategy is similar to or is a subset of a prior fund's strategy, an investment manager will need to consider if and how the manager will show prior performance. A manager must consider all of the facts and circumstances to ensure any "advertisement" showing prior performance is not false or misleading in any manner.

2. Section 206(4) of the Advisers Act states: "It shall be unlawful for any investment adviser by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative."

3. Rule 206(4)-8 under the Advisers Act provides that: "It shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of section 206(4) of the Act (15 U.S.C. 80b-6(4)) for any investment adviser to a pooled investment vehicle to (1) Make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle; or (2) Otherwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle."

4. To the extent the manager wants to show the prior track record or performance of a prior fund to market a new fund, this can raise issues under Rule 206(4)-1 (the "Advertising Rule") and under SEC guidance as to advertising (such issues more fully discussed below) and similar issues in other jurisdictions.

5. The manager must also continue to maintain records in connection with the track record or performance of the prior fund, even after the fund is terminated. Rule 204-2(e)(3)(i) provides that the manager must maintain records necessary to form the basis for or demonstrate the calculation of the performance or rate of return of any or all accounts or securities recommendations for five years from the end of the fiscal year during which the manager last disclosed the related performance.

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6. A manager may consider keeping separate track records for different strategies, sectors or portfolio management teams for the prior fund. Proactively keeping separate records by sub-sector or by portfolio managers may facilitate the use of such records for any future products with more customized or otherwise different strategies than a prior fund, to the extent certain strategies utilized in the prior fund are relevant to the new fund.

III. Launching New Funds: Marketing/Advertising Regulations — U.S.

A. The use of a prior track record or the performance of a prior fund and related marketing materials should comply with the Advertising Rule and SEC guidance on advertising. Investment managers should remember that the Office of Compliance Inspections and Examinations ("OCIE") continues to focus on marketing practices, marketing materials, performance reporting, projected performance and expenses associated with marketing in examinations of U.S.-registered investment managers.

B. Track Records from Prior Funds

The Advisers Act and rules promulgated thereunder do not prohibit investment advisers from including performance information in advertisements, including performance results achieved for a previous employer or previous fund. A manager's use of performance results achieved for a previous fund is not per se misleading, provided that:

1. The persons who are using the track record from the previous fund were primarily responsible for achieving the prior performance results (i.e., no other individual or entity played a significant part in the performance of the accounts);[3]

2. The strategy of the previous fund is comparable to the strategy for the new fund and thus the performance is relevant to prospective clients;

3. All accounts managed in a substantially similar manner by persons using the track record are presented in the marketing materials unless the exclusion of an account does not result in showing materially higher performance;

4. The materials include disclosure indicating that the performance results were from a different fund; and

5. The other requirements relating to the presentation of performance are met.[4]

C. Cherry-Picking/Highlighting Select Investments

Although a manager's use of prior fund performance results is not per se misleading if the above criteria are met, showing only the performance of certain investments of the previous fund raises cherry-picking issues under the Advertising Rule.

1. Specific references to past profitable recommendations of the manager are generally prohibited. This is intended to prevent "cherry-picking" (i.e., mentioning profitable recommendations, but omitting unprofitable ones).

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[3] The portfolio manager claiming the performance results should actually "own" or be primarily responsible for the results. The portfolio manager should be able to prove primary responsibility.

[4] *See Conway Asset Management Inc.*, SEC No-Action Letter (Jan. 27, 1989).

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2. To avoid cherry-picking issues, many investment managers will not show the performance of specific investments, but rather may show an equal number of "winners" and "losers" selected on objective non-performance base criteria to illustrate their investment process and expertise in a particular space. Investment managers should not include performance of specific investments unless they are complying with the rules discussed below.

   (a) There is a limited exception if the advertisement "set[s] out ... a list of all recommendations made by such investment manager within the immediately preceding period of not less than one year,"[5] provided that the advertisement includes certain other statements and disclaimers.

   (b) In the Franklin Management Inc. SEC No-Action Letter (Dec. 10, 1998), the SEC has permitted managers to provide information about a limited number of recommendations so long as the presentation would not be misleading and certain other requirements are met. In particular, securities mentioned must be selected based on objective, non-performance-based criteria (e.g., largest dollar amount of purchases/sales; largest positions held, etc.) consistently applied and the manager may not include performance information on the names mentioned.

   (c) In the TCW Group Inc. SEC No-Action Letter (Nov. 7, 2008), the SEC provided additional guidance indicating that a selective list of recommendations would not be misleading if the manager set out a list of at least 10 holdings that included an equal number of positive and negative recommendations where certain very specific conditions are met and disclosures included.

D. Other SEC Rules and Interpretations Regarding Marketing Materials

1. In addition to the specific rules relating to the use of track records of prior funds and cherry-picking exceptions, an investment manager should be cognizant of other SEC rules and interpretations regarding marketing materials.

   (a) The Advertising Rule identifies a set of four specific practices that are either restricted or prohibited: (i) use of testimonials; (ii) highlighting select investments (discussed above); (iii) use of graphs, charts, formulas, etc.; and (iv) advertisement of "free" services.

   (b) Marketing materials must be fair and balanced and must not make false or misleading statements or omit material facts. For this reason, when marketing a customized product or select strategy from a prior fund, a manager should also consider including the full performance of the prior fund. When marketing materials for customized products managers should be clear about what the performance represents — and does not represent — and about any limitations/assumptions used in showing performance of only a portion of the prior fund, including the fact that the portfolio may have been managed differently given market conditions if the fund was solely focused on the customized portion of the portfolio. In addition, the marketing materials should include disclosure that past performance of the prior fund, and the customized portion of the portfolio, is not representative or indicative of future performance of the new fund.

   (c) Even if marketing materials do not contain any specific item or statement that is in and of itself false or untrue, the materials may nevertheless be deemed misleading or deceptive if

[5] 17 C.F.R. § 275.206(4)-1(a)(2).

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they lead an investor to conclusions that are false or misleading (e.g., a belief that an investment will result in "quick profits").[6]

(d) Track Record Presentation: In addition to the requirements discussed above for the use of performance results achieved for a previous fund, to assist investment managers in determining an appropriate use of their performance in advertisements, the SEC staff set forth a number of practices pertaining to advertising that it believes are inappropriate in a 1986 no-action letter issued to Clover Capital Management Inc.[7] Such practices include, among others:

(i) Net of Fees: Performance information should be presented net of advisory fees, brokerage or other commissions and any other client expenses. A manager also may show gross-of-fees performance results if the manager also: (1) presents net-of-fees with equal prominence; and (2) includes a disclosure statement explaining how the net-of-fees result was calculated and that the gross performance does not reflect the payment of advisory fees or other expenses incurred in the management of the accounts.

(ii) Deduction of Model Advisory Fees: Initially, the SEC required that performance figures be presented net of the actual fees charged to clients. However, the SEC staff subsequently issued a no-action letter to J.P. Morgan Investment Management Inc. indicating that it would not object if an investment manager advertises the composite performance of accounts for which it employs a particular investment strategy by deducting model fees equal to the highest fees charged to any account during the performance period.[8]

(iii) Material Economic Conditions: Marketing materials should include disclosures on the effect of any material market or economic conditions on the results.

(iv) Reinvestments Reflected: Marketing materials should disclose whether results reflect the reinvestment of dividends, gains and other earnings.

(v) Material Conditions to Achieve Performance: All material conditions, objectives, or investment strategies used to achieve the performance advertised (e.g., specific types of equity securities, hedging techniques, etc.) should be disclosed.

(vi) Results Applicable to Select Clients: If applicable, a manager should disclose prominently that the actual results relate to only a select group of the manager's clients, the basis for the selection and any material effect of this practice on the results.

(vii) Consistent Comparisons of Accounts: When presenting performance results of prior funds in the marketing materials of new funds, the manager must present the results of the prior funds in a format that is comparable to that of the funds being marketed.

(viii) Disclosure of Separate and Distinct Accounts: When presenting performance results of a manager's established accounts in the marketing materials of new accounts, a manager must disclose prominently that the accounts being compared are separate and distinct and that prior performance is not indicative of future results.

[6] *See Spear & Staff, Inc.*, Adv. Act Rel. No. 188 (March 25, 1965).

[7] *See Clover Capital Management, Inc.*, SEC No-Action Letter (Oct. 28, 1986).

[8] *See J.P. Morgan Investment Management*, SEC No-Action Letter (May 17, 1996).

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(ix) Composite Substantially Similar: A manager should not present composite performance results unless the accounts within each composite are managed with substantially similar investment objectives, policies and strategies.

2. FINRA Rule 2210 If a manager uses a broker-dealer (placement agent) to solicit investors for the new fund, the rules and interpretive guidance of the Financial Industry Regulatory Authority Inc. ("FINRA") will also apply, including Rule 2210. Rule 2210 is interpreted as generally prohibiting the use of related performance.[9] Accordingly, under this interpretation, FINRA members may not publish or distribute sales materials containing any performance information other than the actual performance of the fund being offered unless it complies with the exception described below.

    (a) Related Performance Defined: Related performance includes the performance of other funds, or accounts managed by the managers; the performance of so-called "clone" funds (e.g., onshore and offshore funds run on a parallel basis); and the performance of funds or accounts that preceded or were converted into the advertised hedge fund.

    (b) Exception to the Rule: FINRA has taken the position that a FINRA member may use sales materials that include related performance information in connection with funds that are exempt from registration under Section 3(c)(7) of the Investment Company Act of 1940, as amended (the "Company Act"), provided that all recipients of those sales materials are "qualified purchasers" within the meaning of Section 2(a)(51) of the Company Act. However, 3(c)(7) funds remain subject to the applicable standards of FINRA Rule 2210, which require that all communications with the public be fair and balanced, as well as other applicable securities laws and regulations.

    (c) FINRA rules also prohibit the use of projected, model or hypothetical returns. Hypotheticals in combination with actual performance are also prohibited.[10]

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[9] *See* NASD Regulation Interpretive Letter, "Guidance Regarding Use of Related Performance Information in Sales Material for Private Equity Funds," (Dec. 30, 2003) (NASD Interpretation), *available at* www.finra.org/Industry/Regulation/Guidance/InterpretiveLetters/P002533.

[10] *See* "NASD Fines Citigroup Global Markets, Inc., $250,000 in Largest Hedge Fund Sales Sanction To Date," Footnote 37, *available at* www.finra.org/Newsroom/NewsReleases/2004/p011819.

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Financing for Funds and Managers

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Hedge Funds

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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 also advises investment managers on strategic transactions involving alternative asset management businesses. Omoz has extensive experience representing sponsors and investors on funds employing credit, distressed investment, buyout, real estate, special opportunities, structured products, activist, multi-strategy and quantitative strategies. Omoz has advised clients on spin-out transactions, acquisitions of minority stakes in hedge fund and private equity firms, joint ventures between investment management firms and strategic transactions involving a change of management of private investment funds. He also represents hedge fund managers and investors in the negotiation of seed-capital transactions, and advises sponsors of private equity firms and hedge fund 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*. Omoz speaks regularly to investment managers about current developments relating to private investment funds. He is a contributor to the *Fund Formation and Incentives Report* (Private Equity International in association with SRZ) and was recently featured in the article "Ringing the Changes," published in *Private Funds Management*.

Omoz received his J.D. from University of Michigan Law School and his B.A., *with highest honors*, from Michigan State University.

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Daniel V. Oshinsky

Dan represents hedge funds, private equity funds, asset managers, specialty finance companies and investment banks in a wide range of financing transactions. He has particular expertise in liquidity facilities, such as CLOs, warehouse lines, leveraged finance vehicles, capital call facilities and fund-of-fund loans. Dan's practice also encompasses a variety of other secured and unsecured finance transactions, both on the borrower and lender side, including cash-flow and asset-based loans, acquisition financing, Term B loans, unitranche loans, workout and restructuring transactions, cross-border transactions and other complex credit arrangements.

Recognized as leader in his field by *The Legal 500 United States* and *New York Super Lawyers*, he co-authored *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and has spoken on topics that include investing in corporate credit and leverage for investment funds.

He received his B.A., *magna cum laude*, from Yeshiva University and his J.D. from New York University School of Law.

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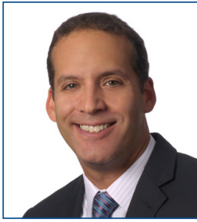

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Eliot L. Relles

Eliot focuses his practice on commercial and corporate finance transactions and, primarily, the representation of hedge funds, private equity funds, commercial finance companies and investment banks in domestic and cross-border secured and unsecured finance transactions, 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. He also counsels clients in debt restructuring and general corporate finance matters, and has represented clients in connection with commercial loan securitizations and capital commitment lines of credit.

Recognized by *New York Super Lawyers* as a leading finance lawyer, Eliot has spoken on topics of interest to the investment management community, including on distressed investing in the retail industry and dividend recapitalizations.

Eliot received his J.D. from Hofstra University School of Law, where he was associate editor of the *Hofstra University Law Review*, and his B.A. from the University of Michigan.

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Regulatory & Compliance

Trading Agreements

Craig Stein

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" and "very thoughtful about the market." *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 authored "U.S. CLOs: Past and Present," published in *The Journal of Structured Finance*, and is co-author of "CLOs and Risk Retention in the U.S. and EU: Complying with the Rules," published in *The International Comparative Legal Guide to: Securitisation 2016.* He spoke on how alternative asset managers and banks work together post-Basel III and on the latest trading-related compliance and enforcement concerns.

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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Financing for Funds and Managers

I. Warehouse Facilities

A. Creation and Purpose of Warehouse Facilities

1. A warehouse facility can be used to finance the purchase and origination of a variety of commercial loans and many other asset classes.

2. Warehouse facilities may provide short-term financings and are often used to "ramp-up" to a CLO. If the warehouse will terminate upon the closing of a CLO, the warehouse SPV can be used as the CLO vehicle, and the fund manager avoids having to transfer assets from one vehicle into a new vehicle at CLO closing. A warehouse facility may also be a permanent facility for the fund, although an exit to a CLO is still feasible, and is often contemplated in an exception to a facility's sale restrictions. However, in that case, assets will have to be transferred from the warehouse vehicle into the CLO issuer.

3. To create a warehouse facility, a fund forms a special purpose vehicle (SPV), contributes an initial pool of assets (which could include cash) to the SPV, and then uses its equity and third-party financing to expand the pool.

B. Structuring Warehouse Facilities

1. The borrower/SPV is designed to be bankruptcy remote. Several features that are built into the organizational documents of the borrower that support the bankruptcy remoteness of the subsidiary include:

   (a) An independent director or manager whose consent is needed for a bankruptcy filing or other material action;

   (b) "Separateness provisions" that require the borrower to maintain separate books and records, and a separate identity from affiliates; and

   (c) Limited purpose provisions to limit the scope of creditors.

2. As a result of *In re Gen. Growth Props.*, 409 B.R. 43, 71 (Bankr. S.D.N.Y. 2009) (secured lenders sought dismissal of special purpose entity Chapter 11 cases arguing that surreptitious dismissal of independent directors on the eve of bankruptcy constituted "bad faith filings"; bankruptcy court denied motions to dismiss because, among other things, "corporate documents did not prohibit this action or purport to interfere with the rights of a shareholder to appoint independent directors to the Board."), lenders will require that organizational documents of the SPV limit independent directors to employees of recognized securitization service providers and only allow replacement of an independent director "for cause."

3. Warehouses may be highly structured facilities, with many elements of a CLO, such as:

   (a) SPV borrower;

   (b) Collateral quality and coverage tests;

   (c) Priority of payment waterfalls; and

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(d) Debt under the warehouse facility may be rated, and the lender may require the underlying loans to be shadow rated, as in a CLO. However, it's rare to have multiple tranches of debt, and typically the lender group is small. Many warehouse facilities in fact do not have rated debt.

4. Warehouse facilities incorporate a predetermined list of eligibility criteria and concentration limits for the SPV's assets, which are generally formulated based on a target asset pool and the lender's credit parameters. Some lenders insist on retaining an approval right for each asset added to the warehouse and, therefore, under such facilities, the lender is only quasi-committed.

5. Other ways warehouses remain distinct from capital markets deals include:

(a) Documentation under a credit agreement or using a total return swap (TRS) instead of a bond indenture;

(b) "Club deals" with a limited number of finance providers;

(c) More likely to be a U.S.-based issuer instead of Cayman-based; and

(d) Administrative agent plays active role in approving portfolio and actions by the collateral manager.

6. Other features of a warehouse:

(a) Assets are held in an SPV owned by the fund (and not "warehoused" on the books of an investment bank, which was common before the credit crisis).

(b) Facilities may have longer revolving periods (as long as three years) followed by an amortization period.

(c) Recourse is limited to the asset pool. Hedge fund sponsors typically are not required to guaranty repayment of the warehouse debt, even if a planned CLO fails to launch.

7. Risk Retention

(a) U.S. risk retention rules became effective for CLOs on Dec. 24, 2016. Whether a warehouse facility is subject to the risk retention rules can be a complicated analysis and a market consensus as to the treatment of warehouse facilities under the U.S. rules has not yet developed.

(b) European risk retention rules have been in effect for several years. European arrangers of warehouse facilities (including their U.S. affiliates) have generally taken the view that warehouse facilities are subject to the European risk retention rules.

II. Leveraging Commitments and Employee Capital; Other Credit Facilities

A. Capital Call Lines and Subscription Facilities

1. General

(a) These facilities are typically used to bridge an investment to be made by a private equity fund prior to receipt of proceeds of capital calls and also occasionally to fund working capital needs of a private equity fund (e.g., to pay fund expenses, including management fees). They are

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also increasingly being used as more conventional longer-term financing for investments. A subscription facility may also be used to provide standby letters of credit. In certain types of facilities, drawdowns are required to be repaid within a short period (e.g., between 90 days and 180 days). This may be required to meet tax structuring needs (such as where the fund has UBTI-sensitive investors) or may be a credit criteria imposed by the lender. In other cases, drawdowns will not be required to be repaid until final maturity.

(b) Typically, a security interest on portfolio assets is not taken; instead, the fund's general partner pledges its right to call capital from commitments to the lender, and limited partners agree (usually pursuant to the partnership agreement of the fund and sometimes through the execution of separate confirmation letters) that their unfunded capital commitments can be called directly by a lender to repay amounts drawn under the facility. Thus, the loan facility is secured by unfunded capital commitments of the limited partners (as well as the collection account for capital contributions). Occasionally, in situations where the fund is near the end of its investment period and unfunded capital is relatively low, the lender may also take a security interest in fund assets.

2. Obligations of Limited Partners

Limited partners are usually required under the fund's partnership agreement to provide financial information about themselves so that the lender can assess individual limited partners' credit. Some limited partners (e.g., certain pension funds or foundations) enter into side letters with a fund pursuant to which they agree only to provide publicly available financial information about themselves. In addition, certain tax-exempt limited partners who want minimal UBTI risk will enter into side letters with the fund that provide that they will be given the chance to pre-fund (usually on notice shorter than the notice required for capital calls) their share of any drawdown from a subscription facility and such limited partners usually also request that no portion of the interest expense charged on the fund's drawdown from the subscription facility will be allocable to a limited partner that has pre-funded its share of such drawdown from the subscription facility. Private equity funds also frequently agree with limited partners to side letter provisions that limit the subscription facility documentation required by a lender to be executed by such limited partners to "customary" documentation and/or documentation "reasonably satisfactory" to such limited partners.

3. Terms of Borrowing

(a) The borrowing base (i.e., the amount of funds that can be drawn down under a subscription facility) is typically equal to a percentage of the unfunded capital commitments of eligible (or "included") limited partners. Limited partners that do not provide sufficient financial information about themselves, or whose credit the lender deems insufficient, are typically excluded from the borrowing base. The default or bankruptcy of a single eligible limited partner should not result in default if outstanding loans are less than the amount of borrowing base. However, if the facility is provided to a "fund of one," a default or bankruptcy event affecting the investor would result in all loans becoming due and an inability to borrow going forward, because the borrowing base will be zero. Note that, even though some investors are not included in the borrowing base because the lender is not sufficiently satisfied with their creditworthiness, the GP would still be pledging its right to call capital from such investors.

(b) The advance rate on drawdowns may be a blended rate that takes into account different advance rates for different limited partners in the borrowing base (e.g., limited partners with higher ratings effectively get to borrow a higher percentage of their collateral). In addition to interest on amounts drawn down from the subscription facility, lenders may also charge a facility fee payable at closing, as well as an unused commitment fee.

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(c) Because lenders are primarily relying on the capital commitments, rather than on the value of the borrower's assets, a subscription facility should include fewer restrictions and controls over a fund's business (which restrictions and controls may be typical in a more typical corporate credit facility). A subscription facility, however, will include many provisions relating to the investors (such as restrictions on transfers and withdrawals by investors or excusing an investor's obligation to fund, limitations on who may become an investor and restrictions on amendments to the partnership agreement or entering into new side letters). Usually, the restrictions are tighter for the investors included in the borrowing base, although since all investor commitments are pledged, the lender may still insist on some control over certain actions relating to excluded investors.

4. Other Advantages to Using Subscription Facilities; Longer-term Facilities

(a) Sometimes, funds prefer to draw down funds under a subscription facility rather than call capital directly from the fund's investors because, in many instances, the preferred return on an investor's capital contribution to a fund only starts ticking when the capital contribution is actually made. If the interest rate at which the fund can borrow from a lender is low compared to the preferred return rate, managers may prefer to keep money drawn down by a fund under a subscription line facility outstanding (and unpaid) for a longer period of time than would otherwise be the case.

(b) The effective interest rate charged on borrowings under a subscription line facility is, in part, based on the creditworthiness of institutional investors who may be investors in the fund. Some of the large institutional investors in private equity funds have very good credit ratings and because of these good credit ratings, it may therefore be possible for a subscription line facility to charge a lower interest rate than would be available for a borrowing to finance fund investments where such investments are pledged as collateral for the lender. A consequence of the foregoing is that some funds are using longer-term capital call lines, particularly when the fund has no UBTI-sensitive investors, in lieu of more traditional asset-based borrowing by the fund.

B. Leveraged Co-investment Arrangements

1. General

(a) Investors in private equity funds usually want the fund's investment team to be aligned with investors by having "skin in the game" and will, therefore, often require investment team members (either individually or collectively) to make capital commitments to the private equity fund. A manager may also want the investment team for a particular fund to participate in the fund's P&L through an actual investment (i.e., capital commitment) in the fund.

(b) Leveraged co-investment arrangements provide a means for a manager to facilitate loans from a lender to the employees and principals of a private equity fund manager to fund capital commitments to be made by such employees and principals to a private equity fund. Managers with sufficient internal capital may loan money to employees to fund employees' capital commitments under a similar arrangement. More typically, a manager will arrange for a lender to provide loans to employees to make capital commitments. Private banks and the private banking units of larger banks are typically the types of lenders who offer leveraged co-investment arrangements.

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2. Terms of Borrowing

   Loan advances are typically made each time the private equity fund makes a capital call and an employee's partnership interest in the private equity fund is usually pledged as collateral to the manager, who then guarantees repayment of the loan to the lender. The manager, in turn, then typically pledges to the lender its right to receive management fees. A more manager-friendly option is for the employees to pledge their interest in the private equity fund directly to the lender. Proceeds from any distribution (other than distributions subject to reinvestment) are usually paid directly to the lender to repay principal on the loan and the lender often requires employees participating in the leveraged co-investment to maintain bank accounts with the lender.

3. Structure

   (a) Instead of having employees invest directly in the fund, sometimes the manager will establish solely for employees:

      (i) A parallel fund in which the loan advances will be invested, which parallel fund will invest alongside the main private equity fund; or

      (ii) A feeder fund in which loan advances will be invested and which will, in turn, invest substantially all of its capital into the main private equity fund.

   (b) The parallel fund option may not necessarily be economically efficient since it would necessitate allocating investments across funds, which entails additional operational costs that are not incurred with a feeder fund structure.

4. Regulatory Requirements

   For securities law purposes employees will need to be accredited investors under Regulation D, and since many private equity funds rely on the Section 3(c)(7) exemption to the Investment Company Act, employees also typically need to be "qualified purchasers" or "knowledgeable employees."

C. Management Company Facilities

1. Management companies sometimes borrow money from lenders in order to meet their working capital needs, which may include paying employee salaries and bonuses. In some instances, the manager/GP of a fund may have significant unrealized carried interest or incentive allocations in the fund which, upon realization, could help pay employee compensation. In such instances, it may be inconvenient or impractical to sell investments in order to have cash to pay compensation and the manager may instead choose to borrow funds to compensate employees.

2. Management company borrowings are usually secured by granting the lender a security interest in management fees. This kind of secured borrowing by the management company can create concerns for investors who may be worried that if the management company defaulted on such borrowings and the lender started receiving the management fees that the management company would otherwise have been entitled to receive, then the management company would not be able to cover its ordinary operating expenses (e.g., salaries, rent, utilities, etc.) and perform its core function as investment adviser to the applicable fund. This is one reason why management company borrowings are often for relatively small amounts.

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III. Master Repurchase Agreements

A. Basic Terms of Repo

1. Under a repo, the fund sells assets to the repo counterparty for cash with an agreement by the fund to repurchase the assets at the end of the term. During the term of the trade, the fund will pay a financing fee to the counterparty, known as the price differential in repo parlance. Cash flows on the asset get paid by the counterparty to the fund (net of the price differential) during the term of the trade.

2. Market-value financing: Repos are typically market-value financing arrangements whereby the fund will be required to deliver margin or collateral if the market value of the asset declines. But depending on asset and business deal, they don't have to be.

3. Complex repos are documented under non-standard negotiated agreements similar to traditional asset-based credit agreement financings (as opposed to industry standard MRA and GMRA for treasuries).

4. Custodial arrangements: Many repos have assets deposited with a custodian, thereby protecting the fund against dealer credit risk. If there is no custodian, the dealer has the right to rehypothecate the assets; but are still required to sell back the assets at termination.

B. Legal Considerations

1. Master repurchase agreements receive special treatment under the U.S. Bankruptcy Code. There are safe harbor provisions that allow a counterparty to liquidate, terminate and accelerate a contract outside of the automatic stay provisions of the Bankruptcy Code.

2. Safe harbor bankruptcy for repurchase agreements and securities contracts:

   (a) Section 555 of the Bankruptcy Code — contractual right to liquidate, terminate or accelerate a securities contract;

   (b) Section 559 of the Bankruptcy Code — contractual right to liquidate, terminate or accelerate a repurchase agreement;

   (c) Section 561 of the Bankruptcy Code — contractual right to terminate, liquidate, accelerate or offset under a master netting agreement and across contracts; proceedings under Chapter 15; and

   (d) Section 362(b)(6) of the Bankruptcy Code — contractual rights, including right to offset or net out any termination value, payment amount, or other transfer obligation, under any security agreement or arrangement or other credit enhancement forming a part of or related to any commodity contract, forward contract or securities contract.

3. Section 101(47) of the Bankruptcy Code — Definition of "Repurchase Agreement"

   The term "repurchase agreement" (which definition also applies to a reverse repurchase agreement)

   (a) Means:

      (i) An agreement, including related terms, which provides for the transfer of one or more certificates of deposit, mortgage related securities (as defined in Section 3 of the

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Securities Exchange Act of 1934), mortgage loans, interests in mortgage-related securities or mortgage loans, eligible bankers' acceptances, qualified foreign government securities (defined as a security that is a direct obligation of, or that is fully guaranteed by, the central government of a member of the Organization for Economic Cooperation and Development) or securities that are direct obligations of, or that are fully guaranteed by, the United States or any agency of the United States against the transfer of funds by the transferee of such certificates of deposit, eligible bankers' acceptances, securities, mortgage loans, or interests, with a simultaneous agreement by such transferee to transfer to the transferor thereof certificates of deposit, eligible bankers' acceptance, securities, mortgage loans, or interests of the kind described in this clause, at a date certain not later than one year after such transfer or on demand, against the transfer of funds;

(ii) Any combination of agreements or transactions referred to in clauses (1) and (3);

(iii) An option to enter into an agreement or transaction referred to in clause (1) or (2);

(iv) A master agreement that provides for an agreement or transaction referred to in clause (1), (2) or (3), together with all supplements to any such master agreement, without regard to whether such master agreement provides for an agreement or transaction that is not a repurchase agreement under this paragraph, except that such master agreement shall be considered to be a repurchase agreement under this paragraph only with respect to each agreement or transaction under the master agreement that is referred to in clause (1), (2) or (3); or

(v) Any security agreement or arrangement or other credit enhancement related to any agreement or transaction referred to in clause (1), (2), (3) or (4), including any guarantee or reimbursement obligation by or to a repo participant or financial participant in connection with any agreement or transaction referred to in any such clause, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with Section 562 of this title; and

(b) Does not include a repurchase obligation under a participation in a commercial mortgage loan.

4. Section 741 of the Bankruptcy Code — Definition of "Securities Contract"

"Securities contract"

(a) Means:

(i) A contract for the purchase, sale or loan of a security, a certificate of deposit, a mortgage loan, any interest in a mortgage loan, a group or index of securities, certificates of deposit, or mortgage loans or interests therein (including an interest therein or based on the value thereof), or option on any of the foregoing, including an option to purchase or sell any such security, certificate of deposit, mortgage loan, interest, group or index, or option, and including any repurchase or reverse repurchase transaction on any such security, certificate of deposit, mortgage loan, interest, group or index, or option (whether or not such repurchase or reverse repurchase transaction is a "repurchase agreement," as defined in Section 101);

(ii) Any option entered into on a national securities exchange relating to foreign currencies;

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(iii) The guarantee (including by novation) by or to any securities clearing agency of a settlement of cash, securities, certificates of deposit, mortgage loans or interests therein, group or index of securities, or mortgage loans or interests therein (including any interest therein or based on the value thereof), or option on any of the foregoing, including an option to purchase or sell any such security, certificate of deposit, mortgage loan, interest, group or index, or option (whether or not such settlement is in connection with any agreement or transaction referred to in clauses (1) through (11));

(iv) Any margin loan;

(v) Any extension of credit for the clearance or settlement of securities transactions;

(vi) Any loan transaction coupled with a securities collar transaction, any prepaid forward securities transaction, or any total return swap transaction coupled with a securities sale transaction;

(vii) Any other agreement or transaction that is similar to an agreement or transaction referred to in this subparagraph;

(viii) Any combination of the agreements or transactions referred to in this subparagraph;

(ix) Any option to enter into any agreement or transaction referred to in this subparagraph;

(x) A master agreement that provides for an agreement or transaction referred to in clause (1), (2), (3), (4), (5), (6), (7), (8) or (9), together with all supplements to any such master agreement, without regard to whether the master agreement provides for an agreement or transaction that is not a securities contract under this subparagraph, except that such master agreement shall be considered to be a securities contract under this subparagraph only with respect to each agreement or transaction under such master agreement that is referred to in clause (1), (2), (3), (4), (5), (6), (7), (8) or (9); or

(xi) Any security agreement or arrangement or other credit enhancement related to any agreement or transaction referred to in this subparagraph, including any guarantee or reimbursement obligation by or to a stockbroker, securities clearing agency, financial institution, or financial participant in connection with any agreement or transaction referred to in this subparagraph, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with Section 562; and

(b) Securities contract does not include any purchase, sale or repurchase obligation under a participation in a commercial mortgage loan.

IV. Total Return Swaps

A. General

Total return swaps are an effective financial tool for private investment funds that want to obtain leverage on their investments in a variety of asset classes, including corporate loans, bonds or even other hedge funds (“reference assets”). Total return swaps enable investment funds to obtain the economic exposure to a reference asset or a portfolio of reference assets on a leveraged basis without taking ownership of the reference assets. The investment fund will receive all of the cash flow benefits of the reference assets without actually owning them. At the end of the transaction, or at pre-determined time periods, the investment fund will make a payment to the swap dealer in an amount

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equal to the decline of the reference assets or the swap dealer will make a payment to the investment fund in an amount equal to the increase in value of the reference assets. During the life of the transaction, the investment fund will receive from the swap dealer all cash flows received on the reference assets and in exchange, the investment fund will make periodic payments to the swap dealer equal to the financing cost of an investment in the reference assets.

B. Ancillary Benefits to Total Return Swaps

There are other reasons for investment funds to utilize total returns swaps, although they are typically ancillary to the main reason, leverage. Other reasons include the ability to outsource the administration and operation of trading and maintaining the reference assets, and the ability to gain exposure to reference assets that an investment fund might not otherwise be able to own due to, for example, eligibility restrictions on ownership and issuer consent rights to any transfer. If the total return swap is characterized as a derivatives contract instead of as a secured financing, there are additional benefits. Typically the swap dealer will not incur a substantial regulatory charge if derivative accounting treatment is achieved. In addition, in the case of a bankruptcy of the investment fund, certain swap agreements are exempt from the automatic stay imposed by the Bankruptcy Code, and the swap dealer may be permitted to terminate and liquidate the transaction outside of the bankruptcy proceeding. These features will enable the swap dealer to provide the investment fund better financing terms.

C. Downside of Total Return Swaps — Voting Rights

Although the investment fund does not have legal ownership of the reference assets, the swap dealer may, for purposes of its hedge, acquire the reference assets. Accordingly, one issue typically negotiated is if, and to what extent, an investment fund will have the right to direct the swap dealer on how to vote on any issues that arise with respect to the reference assets (e.g., votes on amendments to financial covenants, changes to economic terms, etc.). Voting rights are especially important when dealing with reference assets that become defaulted obligations because of a payment default or bankruptcy of the issuers if the investment fund manager wants to control or have some input in dealing with the defaulting obligors. Note that typically the swap dealer has a strong desire to achieve derivative accounting treatment. While there is no bright line rule to ensure derivative treatment, providing the investment fund the sole unfettered right and discretion to direct the swap dealer on voting issues with respect to the reference assets is not a good fact in achieving the desired derivative treatment. Therefore, any voting rights that are passed along to investment funds typically take the form of consultative rights if the investment fund is granted any rights at all.

D. Issues to Consider for TRS Facilities

1. Committed versus non-committed facilities;

2. Recourse versus limited recourse facilities;

3. Market value triggers; and

4. Certain tax considerations: The tax considerations related to a private investment fund's investment in total return swaps are influenced by, among other factors, the fund's jurisdiction, level of trading activities and/or investor base.

E. Dodd-Frank Act

Under the Dodd-Frank Act, a total return swap on a single loan or security is a "security based swap" and a "security," and is now subject to the jurisdiction of the SEC and the anti-fraud and anti-

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manipulation provisions of the Securities Act and the Exchange Act. In addition, total return swaps on a single loan or security must be traded with a counterparty that is an "eligible contract participant" unless there is an effective registration statement for the swap. A total return swap on a portfolio of loans or securities is probably not a "security-based swap," but is a "swap" under the Dodd-Frank Act and, therefore, subject to the jurisdiction of the CFTC and the anti-manipulation provisions of the CEA. Swaps are subject to business conduct standards, reporting and recordkeeping requirements and margin rules and regulations.

F. Safe Harbors

1. Like repos, swaps are also subject to safe harbors from bankruptcy intended to achieve market stability and to decrease systemic market risk by minimizing the effects of a major bankruptcy in the marketplace. The safe harbors prevent the bankruptcy trustee from avoiding margin and settlement payments to other counterparties. Section 362(b)(17) denotes that automatic stays will not apply to swaps; Section 546(g) prevents the bankruptcy trustee from avoiding transfers under a swap; and Section 560 states that default (ipso facto) clauses based on bankruptcy can be enforced by their swap counterparties against the trustee. Master netting agreements are also subject to these same safe harbor clauses via Sections 362(b)(27), 546(j) and 561, respectively.

2. There have been criticisms of these safe harbors. The current broad safe harbors may deny the debtor the ability to assume valuable executory contracts, like swaps, and thus contradict a basic purpose behind bankruptcy policy. Systemic risk might actually be increased where counterparties (with less incentive to monitor the debtor pre-bankruptcy due to its decreased fear of debtor avoidance) could demand successively increasing levels of collateral from the debtor as its financial condition worsens, causing a run on the debtor and exacerbating the market conditions.

3. In the EU, recent legislation called the Bank Recovery and Resolution Directive (or BRRD) gives broad powers to resolution authorities to managing failing financial institutions, including the ability to write down debt owed to creditors, convert debt to equity and to impose temporary stays on termination rights. Having an effective stay upon early termination rights (including suspension of payment and delivery obligations and a stay on the enforcement of security obligations) is viewed as important in preventing the close-out of financial contracts in larger numbers during the resolution period, where the objective of maintaining critical functions and a balanced book could become disrupted. In order to address cross-border recognition of such powers, the EU requires that regulated entities provide for a clause in non-EU law governed contracts whereby creditors recognize the bail-in or temporary stay powers of the EU resolution authority, although it should be noted that BRRD itself doesn't require contracts to recognize the resolution stay (only the bail-in), but instead the EU Member States themselves have committed to coordinated efforts to introducing contractual stay requirements in their own jurisdictions. The stay period varies according to the jurisdiction, where, for example, some jurisdictions maintain a 48-hour period, and others maintain a period lasting until the end of the next business day.

4. While it is clear that a given regulator's "resolution stay" powers can be enforced within its own jurisdiction, it is not clear that they would be enforced outside such jurisdiction (for example, by U.S. courts analyzing N.Y. law-governed swap agreements). In 2016, the ISDA Resolution Stay Jurisdictional Modular Protocol was launched to facilitate adherence with the various contractual stay requirements. The terms of any contractual amendments (including specifics such as types of agreements and defaults) will vary from module to module depending on the member state's jurisdictional requirements. Each dealer will be asking counterparties to adhere to the modules related to the resolution stay requirements to which it is subject. While entering into the Jurisdictional Modular Protocol is required in order to transact with such EU-regulated dealers, it

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should be understood that doing so requires giving up rights and remedies that might otherwise be available in the United States.

5. In the United States, the FDIC recently submitted a notice of proposed rulemaking that would restrict contractual provisions on qualified financial contracts (including swaps) entered into by FDIC-supervised institutions that are subsidiaries of U.S. and non-U.S. "systemically important banking organizations." These restrictions would extend to contracts entered into with non-covered parties, such as hedge funds. In order to address what it perceives as obstacles to orderly resolution under bankruptcy, the FDIC's proposed rulemaking would require covered entities to contractually agree that cross-default rights under a qualified financial contract could not be used in connection with a bankruptcy proceeding. Currently, the proposed rule is not limited to only contracts under non-U.S. law, so potentially all swaps and related contracts with a regulated dealer could be covered, and the current statutory bankruptcy stay safe harbors could be eliminated. The proposed rulemaking is currently in its review and comment period.

V. Fund-of-funds Facilities

A. Nature of Collateral

1. Fund-of-funds financings are a unique, specialized lending area due to the nature of the collateral. A fund-of-funds is a fund that invests in other hedge funds. The sole collateral under a fund-of-funds facility will be:

   (a) The fund-of-funds' interests in the underlying hedge funds; and

   (b) The accounts into which redemption proceeds and distributions are paid to the fund-of-funds.

2. A lender has to assess not just whether the underlying funds are good investments, but also the difficulty of realizing upon the collateral. Realizing on the collateral may be difficult without cooperation of the fund-of-funds borrower.

3. Withdrawal/redemption restrictions have to be assessed, as well as transfer restrictions. The lender will look at "gates," suspensions and lock-ups, as well as provisions that permit in-kind distributions.

B. Role of Underlying Hedge Funds

1. In the past, lenders required upfront consent from the underlying hedge funds. The consent authorized the pledge, provided for admission of the lender and provided for redemption or withdrawals by the lender. The primary problem with this approach was a lack uniformity among consent forms.

2. Currently, a fund-of-funds generally holds its fund interests through a nominee. The nominee's interest is held through a securities account, as described below. It is noteworthy that lenders retain tight control on withdrawals. This can hinder a fund-of-funds' ability to access its cash.

C. Structure of Fund-of-Funds Facilities

1. Fund-of-funds facilities are typically structured as revolving credit facilities secured by the underlying portfolio of fund interests. Custodial control arrangement is entered into through the creation of a perfected security interest in a securities account to which the underlying fund interests are credited. In addition, the lender obtains a perfected security interest in the deposit accounts into which redemption proceeds are placed.

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2. Account control agreements are entered into with the borrower and the custodian bank that holds the accounts.

3. The fund interests are held in the name of the lender or custodian to facilitate redemptions without borrower consent. This structure can create problems for borrowers due to constraints on transferring interests and accessing proceeds of distributions and redemptions.

4. Lending formulas are generally tied to values of the underlying investments and function as a variant of a typical borrowing base. The lending formula caps the lender's exposure to a percentage of the actual collateral values. The formula might be determined by taking the aggregate collateral value and multiplying by a maximum risk ratio. The risk ratio will incorporate a haircut formula that can be lengthy and will be customized to the fund-of-funds' strategy.

5. Maturities vary from one year to longer; some lenders wish to review the facility annually before deciding whether to renew.

D. Use of Loan Proceeds

1. Loan proceeds are used for a variety of purposes:

(a) Finance further investments in pledged funds or new funds;

(b) Finance redemptions, especially larger than anticipated redemptions; and

(c) General liquidity (which may be left untapped).

E. Specialized Provisions

1. Fund-of-funds facilities have tests that allow the lender to react quickly to problems with the portfolio. Some examples include:

(a) Volatility tests (look at variations in standard deviations of NAVs);

(b) NAV and net equity tests (look at the high point during a specified period and then require a certain percentage of high point to be met);

(c) Diversification tests (minimum number of funds and maximum allocation per investment fund or manager; possibly also by type of strategy); and

(d) Material adverse effect tests (will test for adverse changes affecting the fund, the general partner, investment manager and the portfolio).

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Adam serves as co-chair of Schulte Roth & Zabel's White Collar Defense & Government Investigations Group. He focuses his practice on complex civil and white collar criminal matters, including securities, health care, False Claims Act ("qui tam"), the Foreign Corrupt Practices Act (FCPA), export sanctions, criminal tax, money laundering, antitrust and bankruptcy. He counsels corporations and individuals in compliance matters, internal investigations, and Congressional and regulatory matters. He also represents corporations and individuals in high-stakes civil litigation. Adam has defended numerous high-ranking executives and general counsel from some of the world's largest companies, as well as high-profile staff and members of the Senate, Congress, White House and various government agencies, faced with federal and state criminal investigations and indictments. He is a Fellow of the American College of Trial Lawyers and has successfully tried cases throughout the country.

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 2016 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 audit committee investigations, recovery of assets, and obtaining and negotiating corporate deferred and non-prosecution agreements.

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Dan concentrates his practice on the design, structure and regulation of private investment funds, including hedge funds, hybrid funds and private equity funds. He specializes in providing advice to credit funds and advises on insurance dedicated funds. 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 recently presented an SRZ webinar on "Insurance-Dedicated Funds: Tax and Corporate Issues," and at an SRZ breakfast briefing on "Current Issues Impacting Private Investment Funds." He also spoke at the AIMA Navigating the Landscape of Side Letter Terms Seminar. Dan was recently featured in *The Hedge Fund Journal* article "Co-Investments with SRZ's Leading Fund Formation Group" and is a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press). 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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Seetha focuses her practice on anti-money laundering and OFAC compliance, regulatory investigations and enforcement actions, white-collar criminal defense, and criminal and civil forfeiture matters. She has represented companies and individuals in criminal and regulatory investigations by the DOJ, New York Attorney General, CFTC and SEC, as well as conducted internal investigations. She has also advised a range of companies, including hedge funds, private equity funds, banks, broker-dealers and money services businesses on AML and OFAC compliance, as well as other regulatory issues. As a federal prosecutor for nearly a decade, Seetha spearheaded and oversaw DOJ's first major AML prosecutions, including those of HSBC, MoneyGram, Standard Chartered Bank and ING. Much of her work developing and charging criminal cases under the Bank Secrecy Act (BSA) formed the model for AML enforcement that regulators and prosecutors apply today, making her uniquely well-positioned to advise clients in this area. She also has deep experience negotiating the penalty phase of AML and forfeiture matters large and small, ranging from those involving global financial institutions to individual defendants. Seetha is a former Deputy Chief in the Asset Forfeiture and Money Laundering Section (AFMLS), Criminal Division, U.S. Department of Justice, where she was the first head of the Money Laundering & Bank Integrity Unit — DOJ's criminal litigation unit focused on AML and sanctions enforcement. In this role, she supervised BSA cases against traditional financial institutions like banks, as well as those involving emerging areas of BSA enforcement, such as casino gambling, online payment systems and virtual currencies. Seetha also worked closely with state and federal banking regulators and U.S. Attorneys' offices nationwide, providing expert advice on cases involving the BSA, complex money laundering and financial institutions. Prior to her appointment at AFMLS, Seetha served as an Assistant U.S. Attorney for the Southern District of New York for nearly six years, where she worked in the Complex Frauds, Major Crimes and Asset Forfeiture units. As an Assistant U.S. Attorney, she investigated and prosecuted white collar cases involving a wide range of financial crimes, including bank fraud, mail and wire fraud, tax fraud, money laundering, stolen art and cultural property, and civil and criminal forfeiture cases, and she conducted 10 jury trials and argued 10 appeals before the U.S. Court of Appeals for the Second Circuit. 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. An accomplished public speaker, she has presented on topics that include enforcement trends in the financial services industry, effective AML programs and asset forfeiture. Seetha is the co-author of "NYDFS Issues AML/Sanctions Programs and Annual Certification Requirements for Banks, Money Transmitters and Check Cashers" in *Westlaw Journal — Bank & Lender Liability*, "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 represented the government on appeal in 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 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 lawyer in *Benchmark Litigation: The Definitive Guide to America's Leading Litigation Firms & Attorneys*, *The Legal 500 United States* and *New York Super Lawyers*. 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 Burton Awards for Achievement in Legal Writing: In 2008, he won for co-authoring "The Foreign Corrupt Practices Act: Recent Cases and Enforcement Trends," which appeared in the *Journal of Investment Compliance*; and in 2015, he won for authoring "Pension Forfeiture and Prosecutorial Policy-Making," which appeared 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*. He serves on the board of directors of The Legal Aid Society and the board of editors of the *Business Crimes Bulletin*.

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Michael focuses his practice on white collar criminal defense and investigations, securities enforcement, internal investigations, accounting fraud, cybercrime and data security matters, as well as related civil litigation. He also leads internal investigation and cybercrime-related representations for financial services companies and provides guidance on drafting written information security plans and incident response plans for investment advisers. Michael 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, cybercrime, 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 "Federal Banking Agencies Propose New Cybersecurity Regulations" and "NYDFS Proposes Detailed and Sweeping Cybersecurity Regulation for Financial Services Companies," both published in *Harvard Law School Forum on Corporate Governance and Financial Regulation*, and "Securities, Futures Regulators Increase Scrutiny, Expectations on Cybersecurity" in *Bloomberg Brief – Financial Regulation*. 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 an annual guest lecturer at Yale Law.

Michael earned his J.D. from Yale Law School, where he was the John M. Olin Fellow of the Center for Studies in Law, Economics and Public Policy. He earned his B.A., *with distinction*, from Yale University.

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Regulatory Focus: AML, Cybersecurity and FCPA

I. AML

A. Several statutes and regulations aim to prevent the flow of proceeds from crimes and the financing of terrorist operations:

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. Money Laundering

1. Under 18 U.S.C. § 1956, it is a crime to attempt to conduct a transaction that actually involves or is represented to involve (i.e., a sting operation) the proceeds of specified unlawful activity or that is an international transaction, with the purpose of concealing the proceeds, promoting specified unlawful activity or avoiding a transaction reporting requirement. Under 18 U.S.C. § 1957, it is a crime to engage in any transaction involving a financial institution with knowledge that the funds derive from specified unlawful activity. The key term "specified unlawful activity" has an extremely broad definition, incorporating literally hundreds of crimes. Under both sections, the government can prove the requisite intent by showing "willful blindness," such that even if the defendant in fact did not know, it is sufficient that the defendant deliberately avoided learning the necessary facts.

2. Offenses under Sections 1956 and 1957 are punishable by fines up to the greater of $500,000 or twice the value of the transactions and 20 years in prison, or both.[1] The government also has the right to pursue civil fines for those offenses up to the greater of $10,000 or the value of the transactions.[2] It is a separate offense under Section 1956(h), subject to the same penalties, to conspire to commit any offense under 1956 or 1957. Although the language of the civil fine provision does not include 1956(h) — suggesting that a civil fine is not available for a conspiracy that did not amount to an offense — the government has nonetheless sought such civil fines.[3]

C. AML Compliance Programs

1. The BSA requires "financial institutions" to have written, effective AML compliance programs. "Financial institutions" include banks; broker-dealers; any entity required to register under the

[1] *See* 18. U.S.C. §§ 1956-57.

[2] *Id.* § 1956(b).

[3] E.g., *United States v. Lloyds TSB Bank PLC*, 639 F. Supp. 2d 314, 324 (S.D.N.Y. 2009) (government's complaint included 1956(h) as a cause of action but the court dismissed the case for lack of subject matter jurisdiction because the transactions at issue had no connection with the United States).

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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. In 2015, the Financial Crimes Enforcement Network ("FinCEN") issued a proposed regulation that would extend this and other AML requirements to investment advisers registered (or required to register) with the SEC ("RIAs") (the "Proposed Rule").[4] Once the final rule is adopted, RIAs will have six months to comply.

2. The Proposed Rule requires that the AML program be in writing, approved by the RIA's board of directors, and address the "four pillars."[5]

   (a) Establish and implement written policies, procedures and internal controls to ensure ongoing compliance. 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) The RIA must designate an individual or committee responsible for implementing and monitoring the operations and internal controls of the program (the "AML officer"), who is "knowledgeable and competent" regarding the regulatory requirements and the RIA's money laundering risks. Although the AML officer need not be dedicated full time to BSA compliance (depending on the RIA's size and type of services), he or she must be an officer of the investment adviser and thus that role cannot be delegated to a third-party administrator.

   (c) The RIA must provide 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) The Proposed Rule requires independent testing of the AML program 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 — or by employees of the RIA, provided those employees are not involved in the operation or oversight of the AML program.

   (e) Other financial institutions are required to maintain a customer identification program ("CIP") to collect the name, date of birth (for individuals), address and identification number of each account holder who opens an account and to verify enough of that information to form a reasonable belief that it knows the true identity of the account holder.[6] The CIP does not yet

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[4] Firms that rely on exemptions from SEC registration therefore would not be subject to the Proposed Rule, such as venture capital fund advisers under Advisers Act Section 203(l), private fund advisers managing less than $150 million with a place of business in the United States under Section 203(m), family offices relying on Rule 202(a)(11)(G)-1, and CTAs whose business is not predominantly securities-related advice.

[5] Recent enforcement actions demonstrate that deficiencies relating to any of these four AML pillars can result in liability under the BSA. 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); *Cobra Trading, Inc.*, FINRA Case No. 2013035340001 (Feb. 17, 2015).

[6] E.g., 31 C.F.R. § 1020.220.

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govern private investment funds and will not apply to RIAs under the Proposed Rule; however, FinCEN and the SEC intend to create CIP rules for RIAs through joint rulemaking.

D. Suspicious Activity Reports ("SARs")

1. Under the Proposed Rule, RIAs would be required to file SARs. 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. Entities must electronically file a SAR with FinCEN using FinCEN's BSA E-Filing system within 30 days of the reporting investment adviser's determination that potentially suspicious activity occurred, but must immediately notify appropriate law enforcement authority by phone about "violations that require immediate attention," such as suspected terrorist financing or ongoing money-laundering schemes.

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: involves funds derived from illegal activity or is intended or conducted in order to hide or disguise funds or assets derived from illegal activity; is designed to evade the BSA or its implementing regulations; 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 involves use of the RIA to facilitate criminal activity.

3. FinCEN recently issued guidance interpreting the BSA to require filing a SAR when the financial institution "knows, suspects, or has reason to suspect that a cyber-event was intended, in whole or in part, to conduct, facilitate, or affect a transaction or series of transactions." That includes any attempt to compromise a system containing account numbers, credit card numbers, passwords, online banking credentials, balances or other information that could facilitate transactions. FinCEN further interpreted the $5,000 threshold such that the financial institution must report even an unsuccessful attempt if it "put at risk" at least that amount in transactions it could have facilitated.[7]

4. Although the Proposed Rule would allow RIAs to delegate SAR reporting responsibilities to a third party, the RIA remains ultimately responsible. An RIA and another entity subject to the BSA can jointly file a SAR regarding the same conduct. However, all SARs are confidential — disclosing information that would reveal a SAR's existence can constitute a crime, so careful coordination and planning are necessary to submit a joint SAR.

E. Record Keeping and Travel Rules, and Currency Transaction Reports ("CTRs")

1. Financial institutions subject to the BSA (including RIAs if the Proposed Rule is adopted) must record particular information for transmittals of funds in excess of $3,000, including the name and address of the transmittor, the payment instructions received from the transmittor, and information provided about the recipient, and then maintain such records for five years in a manner that is accessible within a reasonable period of time and retrievable by the transmittor's financial institution by reference to the name of the transmittor.

2. Financial institutions must also ensure that the name, address and account number of the transmittor and information provided about the recipient "travels" with the transmittal of funds in

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[7] FIN-2016-A005, Advisory to Financial Institutions on Cyber-Events and Cyber-Enabled Crime at 4 (Oct. 25, 2016).

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excess of $3,000 to the next financial institution in the payment chain, unless the interested party in the transaction is a financial institution such as a bank, broker, dealer or mutual fund.

3. Financial institutions must create and retain records for extensions of credit and cross-border transfers of funds, currency, monetary instruments, checks and investment securities that exceed $10,000. Financial institutions must file CTRs for transactions involving more than $10,000 in currency. When the Proposed Rule goes into effect, RIAs will already be well-equipped to file CTRs as they already file Form 8300 in that circumstance and often do not deal in cash at all.

F. USA Patriot Act Section 314

1. Section 314(a) mandates that financial institutions (including RIAs under the Proposed Rule) search their records upon a law enforcement request made through FinCEN 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 and supply identifying information for the account or transaction in question. Such requests must be kept confidential.

2. The Section 314(b) safe harbor permits (and encourages) financial institutions and some related entities to share information for the purpose of identifying and reporting money laundering or terrorist activity, protected from civil liability. To avail itself of the safe harbor, the financial institution must provide advance notice to FinCEN of its intent to share information and comply with the information protection provisions such as those in the GLB Act (discussed in Part II).[8]

G. Recent AML Developments

1. Customer Due Diligence ("CDD") Rule

(a) In 2016, FinCEN adopted the CDD rule as a "fifth pillar" that will apply to banks, broker-dealers, mutual funds, and futures commission merchants and introducing brokers in commodities.

(b) The CDD rule does not yet govern private investment funds and the Proposed Rule would not require RIAs to comply with the CDD rule. However, the CDD rule does apply to financial institution counterparties of RIAs (e.g., prime brokers) and affects what due diligence demands they may have of RIAs.

(c) Financial institutions must conduct ongoing customer due diligence to identify the human beings who own 25 percent or more or who control each account opened on or after CDD goes into effect March 11, 2018 at the time it is opened, except where the account holder is an ERISA plan, bank, broker, dealer, RIA, registered investment company, state-regulated insurance company or a company with equity securities listed on an exchange. Financial institutions may rely on a certification of the account holder about its beneficial owners unless the financial institution knows something that reasonably calls into question the reliability of that certification. When activity inconsistent with the "customer risk profile" the financial institution developed through its diligence is detected in the account, the financial institution must update its beneficial owner information. Private investment funds and other non-exempt entities must provide their beneficial ownership information to the financial institutions with which they open accounts after the effective date.

[8] The detailed requirements of the safe harbor are set forth in 31 C.F.R. § 1010.540.

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2. The Panama Papers

In early 2015, more than 11 million documents belonging to Panamanian law firm Mossack Fonseca were leaked and then investigated by the International Consortium of Investigative Journalists ("ICIJ"). That law firm allegedly facilitated the concealment of funds through offshore companies and large banks assisted by forming shell companies for certain high-net-worth individuals and politicians. While the ICIJ thoroughly reviewed the underlying documents, it has not released them, instead providing a searchable database listing the shell companies and beneficial owners the papers demonstrate. The DOJ, SFO and many other prosecuting agencies around the world have launched investigations into the activity revealed in the Panama Papers.[9]

3. FinCEN Geographic Targeting Orders

(a) In 2016, FinCEN implemented geographic targeting orders ("GTOs") that require title insurance companies to report on real estate transactions in specific geographic areas that are above a specified value and made without bank financing (i.e., all cash purchases) by legal entities, to provide the identity of the beneficial owners (any person who directly or indirectly owns at least 25 percent of the entity); the names, addresses and taxpayer identification numbers of every member of an LLC purchaser; and the identity of the individual who was primarily responsible for representing the purchaser in the transaction. The program arises out of a concern that illicit actors are storing or concealing assets in the form of luxury real estate, while hiding their identities through the use of shell companies.

(b) In January 2016, FinCEN issued GTOs covering property over $3 million in Manhattan and over $1 million in Miami-Dade County. Effective August 2016, FinCEN expanded the program into all boroughs of New York City; Miami-Dade, Broward and Palm Beach Counties; Los Angeles County; San Francisco, San Mateo and Santa Clara Counties; and Bexar County (San Antonio, Texas), specifying monetary thresholds particular to each of those regions.[10]

H. Other jurisdictions also have AML laws. For example, the Cayman Islands has extensive laws and regulations relating to money laundering such as the Proceeds of Crime Law, criminalizing the transfer of funds derived from any foreign activity that would be a crime if committed in the Cayman Islands.

I. Recent Adjustments in OFAC Sanctions Policies

1. Cuba

(a) In January 2016, OFAC and the Department of Commerce's Bureau of Industry and Security ("BIS") amended regulations to permit export and re-export to Cuba of various goods aimed to serve the general people of Cuba but not its state-owned enterprises. Various general licenses permitted greater travel to Cuba for specific purposes.[11]

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[9] While it appears that the DOJ does not yet have direct access to the Panama Papers themselves, the DOJ has sought to obtain those documents and other information from the ICIJ and law enforcement agencies in Panama have conducted raids of Mossack Fonseca's offices. Even if the documents are not revealed or would not be admissible in evidence, the leads the data provide will lead to ample enforcement activity. Rupert Neate, Panama Papers: US launches criminal inquiry into tax avoidance claims, The Guardian (Apr. 19, 2016), *available at* www.theguardian.com/business/2016/apr/19/panama-papers-us-justice-department-investigation-tax-avoidance.

[10] Press Release, FinCEN, FinCen Expands Reach of Real Estate "Geographic Targeting Orders" Beyond Manhattan and Miami (July 26, 2016), *available at* www.fincen.gov/news/news-releases/fincen-expands-reach-real-estate-geographic-targeting-orders-beyond-manhattan.

[11] The general licenses include 31 C.F.R. §§ 515.545 (transmission of informational materials), 515.562 (official government business), 515.563 (journalistic activity), 515.564 (professional research or professional meetings), 515.565 (educational activities or people-to-people travel), 515.566 (religious activities), 515.567 (public performances and exhibitions), 515.574 ("support for the Cuban people"), 515.575 (humanitarian projects) and 515.576 (activities of private foundations or research or educational institutes).

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(b) OFAC also permitted U.S. depository institutions to issue, advise, negotiate, pay or confirm letters of credit, including for financial institutions that are Cuban nationals. In October 2016, OFAC issued a general license authorizing U.S. nationals to make remittances to third-country nationals for travel to, from or within Cuba so long as the traveler would qualify for a travel general license if the traveler were subject to U.S. jurisdiction.[12]

(c) Generally speaking, however, U.S. persons remain forbidden from engaging in transactions with Cuba as a country.

2. Iran

In early 2016, Iran verifiably met its nuclear commitments so the United States and EU lifted various "secondary sanctions" so that non-U.S. persons could engage in certain business activities and transactions with Iranian persons. U.S. persons have general license to import Iranian carpets and certain foods but must still facilitate such transactions via a third-country bank or money service; have general license to establish or alter corporate policies to engage in the newly permitted activities, though U.S. persons cannot have any involvement in day-to-day operations affecting Iran; and may apply for specific license for transactions involving aircraft parts. None of those U.S.-person activities can involve a person on the SDN list, though OFAC removed over 400 persons from the SDN and other sanctions lists. Overall, U.S. persons are prohibited from engaging in transactions with Iran as a country.

3. Russia/Ukraine

(a) Following the Russian annexation of Crimea, Ukraine, OFAC and BIS acted pursuant to Executive Order 13662 to impose a sectoral sanctions regime and adding certain entities to the SDN list, to limit Russia's defense and related materials sector. U.S. persons cannot issue financing with maturity of greater than 30 days to various banks on the Sectoral Sanctions Identifications list ("SSI list"), including Russia's largest bank, Sberbank, and defense conglomerate Rostec; nor financing with maturity of greater than 90 days to various companies in the energy sector. Although U.S. persons cannot hold a direct interest in any of the debt governed by the directives OFAC issued pursuant to Executive Order 13662, a general license permits transactions in derivative products linked to the debt those directives prohibit. Nonetheless, U.S. persons must not invest in the new equity of entities on the SSI list.

(b) BIS expanded export restrictions on its BIS Entity List, under which a specific license is required to export or re-export items subject to the Export Administration Regulations to the listed persons, with a presumption of denial.

(c) The EU issued similar economic and export sanctions.

(d) Sanctions vis-à-vis Russia are likely to remain in flux as the new administration takes power and following confirmed intelligence reports of persons associated with Russia hacking political candidates and parties in an effort to influence the 2016 presidential election.

II. 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

[12] Department of the Treasury, Frequently Asked Questions Related to Cuba (Oct. 14, 2016), *available at* www.treasury.gov/resource-center/sanctions/Programs/Documents/cuba_faqs_new.pdf.

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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.

A. Regulatory Interest in Cybersecurity

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 federal and state statutes and regulations that require data security.

1. Protection of Personally Identifiable Information ("PII")

(a) Historically, applicable laws have been mostly concerned with protecting the PII of human beings (e.g., social security numbers or home addresses).

(b) At present, 47 states (and Washington, D.C., Puerto Rico, Guam and the Virgin Islands) have PII protection laws. These include all states other than Alabama, New Mexico and South Dakota.[13]

2. The Gramm-Leach-Bliley Act ("GLB Act")[14]

(a) The GLB Act requires financial institutions to protect a broad scope of "nonpublic personal information" about the individuals to whom the institutions provide financial products or services, information protected by the Health Insurance Portability and Accountability Act ("HIPAA") and by the Federal Education Rights and Privacy Act ("FERPA").[15]

(b) The Securities and Exchange Commission (the "SEC") and the Financial Industry Regulatory Authority ("FINRA") enforce two GLB Act regulations:

(i) Section 30 of Regulation S-P:[16] Requires brokers, dealers, investment companies and registered investment advisers to adopt written policies and procedures designed to protect "customer records and information."[17]

(ii) Regulation S-ID, the Identity Theft Red Flags Rules: Requires 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."[18]

(c) The SEC has brought enforcement cases against firms for violating Regulation S-P by failing to follow or enforce cybersecurity policies and procedures.[19] FINRA has also brought supervision and enforcement actions under Regulations S-P and S-ID against broker-dealers.[20]

[13] The National Conference of State Legislatures provides a list of the relevant laws, *available at* www.ncsl.org/research/telecommunications-and-information-technology/security-breach-notification-laws.aspx.

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

[15] 16 C.F.R. § 313.1 *et seq.*

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

[17] 17 C.F.R. § 248.30.

[18] 17 C.F.R. § 248.201(d)(1).

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3. The 1940 Acts

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.[21]

4. SEC Office of Compliance Inspections and Examinations ("OCIE")

(a) In 2014 and 2015, OCIE released Risk Alerts announcing that it would make cybersecurity a focus of its exams in those years. [22] The Risk Alerts made clear that OCIE would not confine its exams to PII but would address cybersecurity risks in general, including "misappropriation of funds, securities, sensitive Firm information, or damage to the Firm's network or data."

(b) Topics that OCIE addressed in the Risk Alerts included: governance and risk assessment, access rights and controls (including remote access); data loss prevention; vendor management; training; and incident response. Although OCIE did not issue a specific cybersecurity Risk Alert in 2016, evaluating cybersecurity remains a major part of OCIE's exams.[23]

(c) For example, in 2016, the SEC imposed a $1-million fine on Morgan Stanley Smith Barney LLC where an employee accessed customer information and listed it for sale online over a three-year period. The order noted that Regulation S-P requires every broker-dealer and registered investment adviser to adopt written policies and procedures that "address administrative, technical and physical safeguards reasonably designed to: (1) [e]nsure the security and confidentiality of customer records and information; (2) protect against any anticipated threats or hazards to the security or integrity of customer records and information; and (3) protect against unauthorized access to or use of customer records or information that could result in substantial harm or inconvenience to any customer."[24]

5. SEC Enforcement Action: *R.T. Jones*

(a) In 2015, investment adviser R.T. Jones consented to entry of a cease-and-desist order and a $75,000 fine relating to poor cybersecurity and a breach of PII. Notably, the breach occurred before OCIE began its "cyber sweeps," and the co-chief of the SEC Enforcement Division's

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[19] *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.

[20] *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. The SEC Investment Management Division issued guidance that provided more detail on the basic steps the SEC staff expect, observing 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." SEC, Division of Investment Management, IM Guidance Update (April 2015), No. 2015-02, "Cybersecurity Guidance."

[21] *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).

[22] SEC, OCIE, "OCIE's 2015 Cybersecurity Examination Initiative," Vol. IV, Issue 8 (Sept. 15, 2015); SEC, OCIE, "Risk Alert: OCIE Cybersecurity Initiative," Vol. IV, Issue 2 (April 15, 2014).

[23] Securities and Exchange Commission, OCIE: Examination Priorities for 2016, *available at* www.sec.gov/about/offices/ocie/national-examination-program-priorities-2016.pdf.

[24] *In the Matter of Morgan Stanley Smith Barney LLC*, Securities Exchange Act of 1934 Release No. 78021, Admin. Proc. File No 3-17280 (SEC June 8, 2016) at 2, *available at* www.sec.gov/litigation/admin/2016/34-78021.pdf.

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Asset Management Unit acknowledged that there was "no apparent financial harm to clients."[25]

(b) The order stated 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." 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." "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."[26]

(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]." 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."[27]

6. The CFTC

(a) The National Futures Association ("NFA"), the self-regulatory organization for the futures industry, with the approval of the Commodity Futures Trading Commission ("CFTC"), issued new standards for its members, which became effective March 1, 2016:

(i) Members are required to implement a written information systems security program, and in doing so 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.[28]

(b) CFTC Commissioner Sharon Bowen mentioned that future regulation may: (1) require each registrant to designate a chief information security officer; (2) require registrants to file annual or quarterly reports on the state of their cybersecurity program; (3) require 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) require an independent audit or annual penetration testing for all registrants.[29] While some of these proposals are consistent

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[25] 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.

[26] *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 2-3, *available at* www.sec.gov/litigation/admin/2015/ia-4204.pdf.

[27] *Id.*

[28] National Futures Association, Interpretive Notice, NFA Compliance Rules 2-9, 2-36 and 2-49: Information Systems Security Programs (Aug. 20, 2015), *available at* www.nfa.futures.org/nfamanual/NFAManual.aspx?RuleID=9070&Section=9.

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

with current best practices, the reporting of any material event "within minutes" would be a new requirement for fund managers.

7. The European Union

   (a) While the United States enacted the GLB Act and Regulation S-P, the EU enacted the Data Protection Directive.[30] One important consequence of the difference between the U.S. and EU regulations is that affiliated groups of companies can share data of a U.S. customer among each other without individual customer approval, but companies must obtain approval from an EU customer prior to sharing the customer's information with an affiliate or otherwise transferring the data outside the EU. Without a safe harbor or equivalent legal mechanism, 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. It would be similarly problematic for a U.S. investment adviser to process EU investor data at a global IT back office located in New York or Connecticut.

   (b) Although the EU implemented a safe harbor that 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, concerns over mass surveillance uncovered by Edward Snowden prompted the EU's highest court to rule the safe harbor invalid.[31] The United States and EU have since reached a new agreement known as the Privacy Shield which allows similar self-certifications on behalf of U.S. entities, provides greater transparency and redress rights for EU citizens, and allows most information to be transferred so long as the EU citizen has not opted out. The EU citizen has to affirmatively opt in, however, to permit the transfer of sensitive information if the information will be disclosed to a third party or used for a purpose other than the purposes for which it was originally collected.[32]

8. Many other state and federal laws may affect the cybersecurity measures your fund is required or encouraged to take. At a minimum, your fund should engage in a risk-based approach to assess the threats and vulnerabilities of your information systems in order to protect not only PII but also other assets important to your business, such as trade secrets or infrastructure critical to your business.

B. Recent Proposals Forecast Expansion of Cybersecurity Regulation

Several regulators have recently announced proposed regulations or rules setting forth detailed cybersecurity obligations for the entities subject to their authority and with little regard for the potential conflicts an entity subject to multiple regulators may face in attempting to comply. What is clear is that cybersecurity is becoming even more of a compliance obligation and that funds can expect scrutiny of their information security systems from multiple regulators.

1. The New York Department of Financial Services ("NYDFS") issued a proposed regulation that would require banks, consumer lenders, money transmitters, insurance companies and certain other financial service providers to formalize their cybersecurity program, restrict access so employees and vendors are permitted to access only the information they need, report breaches to the

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[30] 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.

[31] *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.

[32] The full text of and commentary on the Privacy Shield is available at www.privacyshield.gov. *See also* European Commission, Fact Sheet: EU-U.S. Privacy Shield (July 2016), *available at* http://ec.europa.eu/justice/data-protection/files/factsheets/factsheet_eu-us_privacy_shield_en.pdf.

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superintendent, destroy no longer needed information but preserve logs and access records, and annually certify compliance.[33] Although the NYDFS does not directly regulate private investment funds, they will likely be affected when the banks it regulates begin to require additional representations and warranties from their counterparties.

2. The Federal Reserve, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation ("FDIC") issued an advance notice of proposed rulemaking that aims to protect "those entities that are critical to the functioning of the financial sector" and their service providers. The notice urges a risk-based approach that builds cybersecurity into general governance and risk management structures, inventories the internal and external cyber resources on which its business depends, and set out in writing their incident response plans. The notice would require that entities substantially mitigate the likelihood of disruption of any "sector-critical" systems.[34]

C. Some Best Practices

1. NIST Framework

(a) The National Institute of Standards and Technology ("NIST," a division of the U.S. Commerce Department) Framework[35] provides a thoughtful and flexible approach to cybersecurity developed in collaboration between the government and the private sector.

(b) Several of the regulators mentioned in Section A above have explicitly referred to the NIST Framework as a source of guidance for what "reasonable security measures" mean. For example, the 2014 and 2015 OCIE Risk Alerts called upon registrants to "identify any published cybersecurity risk management process standards" upon which the entity modeled its information security architecture and processes.[36] And the proposed regulations described in Section B above claim to further develop the Framework. While the Framework is not law, it should not be ignored lightly because several regulators have endorsed it.

(c) The Framework is meant to remain flexible enough to accommodate technology and business change so it does not prescribe specific tools or products. The Framework has several parts, the "Core," the "Profile" and the "Implementation Tiers":

(i) "The Framework Core is a set of cybersecurity activities, outcomes, and informative references that are common across critical infrastructure sectors."[37] Its "functions" —

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[33] Cybersecurity Requirements for Financial Services Companies (Sept. 13, 2016) (to be codified at 23 NYCRR Part 500), *available at* www.dfs.ny.gov/legal/regulations/proposed/rp500t.pdf; Joseph P. Vitale et al., NYDFS Proposed Detailed and Sweeping Cybersecurity Regulation for Financial Services Companies (Sept. 15, 2016), *available at* www.srz.com/images/content/1/4/v2/145023/091516-NYDFS-Proposes-Detailed-and-Sweeping-Cybersecurity-Regula.pdf.

[34] Joint Advance Notice of Proposed Rulemaking, Enhanced Cyber Risk Management Standards, *available at* www.federalreserve.gov/newsevents/press/bcreg/bcreg20161019a1.pdf; Joseph P. Vitale, et al., Federal Banking Agencies Propose New Cybersecurity Regulations (Oct. 26, 2016), *available at* www.srz.com/images/content/1/4/v2/144958/102416-Federal-Banking-Agencies-Propose-New-Cybersecurity-Regula.pdf.

[35] 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. The Framework builds on prior standards such as COBIT and ISO 27001.

[36] *See also,* Luis Aguilar, SEC Commissioner, Boards of Directors, Corporate Governance and Cyber Risks: Sharpening the Focus, Cyber Risks and the Boardroom Conference ("At a minimum, 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."), *available at* www.sec.gov/News/Speech/Detail/Speech/1370542057946.

[37] The Framework, at 1.

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identify, protect, detect, respond and recover — trace "the lifecycle of an organization's management of cybersecurity risk"[38] and help it learn from past security incidents.

(ii) The Profile is 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."[39]

For example, a firm with a Profile has something to show its vendors and third parties, making it easier to describe what needs to be protected, and what third parties must do before gaining access. Similarly, a firm can request the third party's Profile.

(iii) Framework Implementation Tiers range from partial (Tier 1) to adaptive (Tier 4), describing: (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."[40] Firms select the level that meets the firm's goals and "is feasible to implement."[41]

2. Firm-level Risk Assessments

(a) Firms should maintain a detailed inventory and understanding of their cyber infrastructure, including physical devices, the software platforms and applications used on the network, network resources, connections and data flows (including where customer data is housed).[42]

(b) The SEC is concerned with firms' vulnerability to cybersecurity risks in general, including "misappropriation of funds, securities, ... [and] Firm information[.]"[43] Managers should accordingly review existing related policies — such as controls on processing redemption requests and IT safeguards — in a cybersecurity context, discover where the gaps are in the firm's security, and close them.

(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.

(d) Keep in mind that threats are not always brute-force attacks. Phishing is a very common tactic that often involves an email with an urgent or dire call to action that attempts to convince the recipient to click on a link to a site that will download malware onto the recipient's computer. Spoofing is a slightly more sophisticated threat in which the communication appears to come from a person who should not be questioned, such as a boss or an important customer. Fund administration company SS&C Technologies is currently facing a lawsuit seeking eight-figure damages where attackers spirited away $6 million by sending emails from a slightly misspelled

[38] *Id.* at 4.

[39] *Id.* at 5.

[40] *Id.* at 9.

[41] *Id.*

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

[43] *Id.* at 7.

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version of the client's domain name. SS&C has moved to dismiss the complaint, arguing that the attackers provided valid client credentials for the wire transfers.[44]

(e) FinCEN recently published a helpful and easily digestible advisory outlining various "e-mail compromise" attacks. Some impersonate corporate executives to direct unauthorized transfers and others aim to take the assets of individuals by targeting or impersonating realtors, lenders or financial institutions. The FinCEN advisory provides several examples and lists red flags that can provide insight in crafting the policies entities need to ensure its employees do not inadvertently fall for these schemes.[45]

3. Cybersecurity Personnel

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[46] — 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.

4. Records of Cybersecurity Incidents

(a) Firms should maintain appropriately detailed records relating to cybersecurity incidents, including granular detail on various 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."

(b) Such records are a valuable tool for firms conducting internal investigations. 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. Log records (e.g., web server access logs and secure shell server logs) are often essential and should be protected against being overwritten or deleted.

5. 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 "ransomware" attacks, in which the attacker encrypts all of a firm's data and blackmails the firm in exchange for the decryption key.

D. Bring Your Own Device ("BYOD") Challenges

1. Many firms permit employees to use cell phones and other devices to access firm systems — the same devices they use for personal activities.[47] That trend poses challenges in that devices are

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[44] Sam Macdonald, SS&C seeks dismissal of CTA's "unmerited" $20m cyber damages claim, HFM Week (Oct. 5, 2016 7:16am), *available at* https://hfm.global/hfmweek/news/ssc-seeks-dismissal-of-ctas-unmerited-20m-cyber-damages-claim.

[45] FinCEN, Advisory to Financial Institutions on E-Mail Compromise Fraud Schemes (Sept. 6, 2016), *available at* www.fincen.gov/sites/default/files/advisory/2016-09-09/FIN-2016-A003.pdf.

[46] The NYDFS Proposed Regulation discussed above would require NYDFS-regulated entities to name a chief information security officer.

[47] In fact, the National Labor Relations Board has held that firms cannot unduly restrict employees' personal use of business devices, as to do so would chill employees' ability to organize; nor can employers restrict employees' speech about their dissatisfaction with the employer on social media. *See Durham Sch. Servs., L.P.*, 360 N.L.R.B. 85 (2014) (prohibition on sharing information "related to the company or any of its employees or customers" was overbroad and too vague under the NLRA); *Landry's Inc.*, No. 32-CA-118213 (N.L.R.B. A.L.J. June 26, 2014) (policy that urged employees not to post about the company was acceptable, however, because it was not an outright prohibition).

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easily lost or stolen, could be accessible to employees' friends and family and give malware a new route into the firm's internal systems. Data traveling wirelessly can be intercepted and cloud storage is unsecure and out of the firm's reach.

2. Firms must proceed cautiously before resorting to surveillance or remote wiping of personal devices to secure business data. The Electronic Communications Privacy Act generally prohibits private entities from wiretapping unless certain conditions are met. The Stored Communications Act makes it a crime to gain surreptitious access to stored communications like email, social media messages and text messages. Employers therefore cannot log into employees' web-based email or social media accounts without consent.[48] The Computer Fraud and Abuse Act prohibits anyone from intentionally accessing a computer without authorization, such as when an employer accesses employees' phones, devices, or accounts without authorization.[49] Twenty-four states have passed so-called "anti-snooping" laws prohibiting employers from demanding passwords to access personal email and social networking sites.[50]

3. To avoid running afoul of these statutory protections, and to protect firm information, firms should: obtain advance authorization to access and wipe the firm's information stored on employee-owned mobile devices; consider mobile management software that can separate firm information from personal information; clearly delineate where work cannot be done (e.g., prohibit firm work on personal email accounts); and 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.

4. Proprietary and Trade Secret Information

   (a) Information is not a trade secret in a misappropriation case unless the employer has taken "reasonable measures to protect" the information.[51] That evidentiary burden is difficult to meet when the information walks out the door every day in employees' pockets.

   (b) Employees can misappropriate firm information in a variety of ways. To protect firm information, in addition to confidentiality agreements or policies, firms should take technical precautions, including restricting access to trade secret data, disabling transmission of information to portable drives, encrypting information and compartmentalizing information (so that no single individual can misappropriate a particular trade secret).

5. Elements of a BYOD Policy

   (a) Restrictions: A comprehensive BYOD policy should include provisions regarding password protection, encryption of firm data that is stored on the device, lock or wipe after a certain number of unsuccessful access attempts, restrictions on the source of apps (e.g., only Apple or Google), and no friends or family access. If a firm chooses to allow cloud storage for corporate data, it should carefully select an enterprise-grade provider with better encryption and the

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[48] *See*, e.g., *Pure Power Boot Camp v. Warrior Fitness Boot Camp*, 587 F. Supp. 2d 548 (S.D.N.Y. 2008). *But see*, *Front, Inc. v. Khalil*, 2013 N.Y. Misc. LEXIS 3157 (N.Y. Co. 2013) (firm could properly access content stored directly on firm drives even though it reflected personal email and social media content).

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

[50] Specifically, 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. There is no New York or federal equivalent yet.

[51] *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).

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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 strong passwords.

(b) Monitoring: In addition, employers should alert employees that they have no privacy expectation in firm data or material transmitted through 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, including upon termination of employment. Firms should obtain advance consent to inspect the device upon termination to ensure firm data is not stored in the personal areas of the device that mobile management software will not wipe.

(c) 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.

(d) Record Keeping Obligations: Employers should make sure that they have access to and maintain all information that is subject to record keeping obligations. For example, if text messages 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.[52] 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 on any platforms used for communicating with clients, even, e.g., LinkedIn.

E. Third-party Risks: Vendor Management

(a) A vulnerability of a third party with access to the firm's internal systems can quickly become the firm's vulnerability. Such third parties include fund administrators, prime brokers, consultants and commercial vendors. There is not yet a standard Due Diligence Questionnaire ("DDQ") to evaluate the cybersecurity of third parties though the American Institute of Certified Public Accountants has released "Service Organization Control" standards that rate the robustness of an entity's written policies and the technical fortitude of its systems.[53]

(b) In choosing a vendor, investigate its creditworthiness; ask for customer references; review key documents such as the vendor's written information security program, business continuity plan, and incident response plan; ask the vendor which standards it follows; require the vendor to commit to follow firm instructions including litigation and regulatory holds; determine the access its vendors will have to your sensitive information and conduct diligence on them.[54]

F. Data Breaches

1. Incident Response Plan

(a) An Incident Response Plan defines a firm's procedures for reporting and responding to security incidents that may compromise the availability, integrity and confidentiality of its information systems, network resources or data. Such a plan might include:

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

[53] Am. Inst. of CPAs, Service Organization Controls (SOC) Reports for Service Organizations, *available at* www.aicpa.org/InterestAreas/FRC/AssuranceAdvisoryServices/Pages/ServiceOrganization%27sManagement.aspx.

[54] *See also* 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/resources/model-cybersecurity-contract-terms-and-guidance-for-investment.html.

(i) Developing and testing procedures, and training personnel;[55]

(ii) Assigning responsibility for managing the response to the incident, determining the scope of the incident, and notifying the security incident response team;

(iii) Assessing the risk of continued operations and preventing further loss or damage;

(iv) Determining the cause of a security incident and plugging the holes;

(v) Returning impacted data and services to full operational status; and

(vi) Identifying lessons that make future responses more effective.

(b) Develop responses to the most likely attacks (e.g., phishing and insider threats). Do not just think of the dramatic incidents. A security incident could be a breach by an outside attacker, but it also includes events like the loss of laptops, mobile phones or RSA keys.[56]

(c) Assemble a team that includes various parts of the firm such as tech security, tech operations, PR, audit and legal. Specify points of contact for each department, allocate responsibilities and distribute the list in a way that it can be accessed in an emergency.

(d) Test the response plan — regularly, not just when it is first developed. Update it regularly, especially when significant change occurs, such as switching to a new off-site data center, or implementing a major piece of software — and after every significant incident.

2. 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.

(a) Crime Policies and Fidelity Bonds: May cover theft of funds or tangible property such as losses due to computer theft, forgery or electronic fraud but typically do not cover against loss due to stolen data, unauthorized disclosure of information, or system losses due to a virus or other electronic attack.

(b) General Liability Policies: Typically provide coverage bodily injury or property damage caused by an occurrence and do not typically extend to data breach loss.[57]

(c) Cyber Risk Insurance Policies

(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

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[55] 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. Training will go a long way toward mitigating that risk.

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

[57] *Zurich Am. Ins. v. Sony*, 2014 WL 3253541 (N.Y. County Feb. 24, 2014) (third party hack of the PlayStation did not constitute a "publication" by Sony and was not covered); *Recall Total Information Mgtmt., Inc. v. Fed. Ins. Co.*, 317 Conn. 46 (Conn. 2015) (loss of computer tapes containing PII was not a "publication" of the information stored on the tapes).

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security policies and procedures. The insurer's underwriting and loss control professionals can provide valuable feedback about the manager's information security profile. Cyber risk policies are not yet standardized, so careful attention must be paid to how a particular policy defines the key terms.

(ii) Policies should cover claims by third parties: customers, investors, business partners and regulators. Such claims may be based on 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 applicable privacy laws and 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 should include defense costs. News of a data breach are often followed by a purported class action lawsuit seeking damages on behalf of customers. Even if unsuccessful, defense costs for such suits can be significant.

(iv) First-party claims include claims for costs incurred to investigate and respond to data breach incidents. Covered costs should include items such as data restoration costs, forensic analysis of the scope and cause of the breach, legal analysis of reporting and notification obligations, privacy notification services (including credit monitoring), and crisis management expenses, and possibly also business interruption losses and expenses, cyber extortion response costs, and regulatory fines and penalties.

(d) Cyber risk policies typically contain a lengthy list of exclusions, but most simply exclude losses covered by traditional insurance. Other exclusions apply to fraud, intentional illegal conduct or known existing breaches.

3. Reporting

(a) When to report a data breach (and what to report about it) is very fact-specific and depends on applicable state and federal law. 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. Many state laws require that persons whose PII was affected be notified within a reasonable time, but allow postponing that notification in order to cooperate with law enforcement.[58]

(b) While there is often no obligation to report a security breach to the SEC or to prepare any particular document, an internal breach report and documentation may be useful in demonstrating the firm's efforts to address information security concerns.

(c) The firm's investigation and breach report are unlikely to be protected by attorney client privilege or work product. Having a lawyer conduct and direct the investigation, however, can make it more likely that a court will protect the communications made for the purpose of legal advice that occurred during the investigation.

(d) Document as much as possible — actions that are performed by IT, conversations with users and system owners regarding the incident, etc. The point is to know what happened when,

[58] *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).

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and what the decision-making process was. This information may help a firm to improve its future responses and 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. But to the extent possible, preserve evidence in a way that doesn't alert the suspected culprit. For example, do not assume that you should turn off computers — that will result in loss of volatile memory. Consult law enforcement and your tech and security team before you disconnect from the Internet.

4. Communicating and Working with Law Enforcement

(a) On the one hand, getting law enforcement involved diminishes the firm's control; criminal cases often (but not always) put related civil suits on hold.[59] On the other hand, reaching out to law enforcement means the firm and law enforcement come into contact on the firm's terms; the Secret Service or FBI may ultimately reach out to the firm anyway if PII was affected. And law enforcement has tools private firms do not (e.g., search warrants, international law enforcement contacts).

(b) Get outside counsel involved in dealings with law enforcement. And always speak accurately to investigators; though the firm may have to discuss aspects of a hack it has seen but doesn't understand. Consider personal relationships your firm or outside counsel have that may improve the responsiveness of or facilitate communication with law enforcement.

III. FCPA

A. The Foreign Corrupt Practices Act ("FCPA") has two prongs:

1. Anti-bribery provisions prohibit "offering to pay, paying, promising to pay, or authorizing the payment of money or anything of value (tangible or intangible) to a foreign official in order to influence any act or decision of the foreign official in his or her official capacity or to secure any other improper advantage in order to obtain or retain business."[60]

   Apply to bribes paid directly and bribes paid indirectly through third-party intermediaries (e.g., agents, placement agents, sub-agents, consultants, representatives, distributors, resellers, introducers/finders, joint venture partners, brokers, contractors, lawyers, accountants, lobbyists).

2. Accounting provisions require issuers to maintain accurate books and records, and establish a system of internal controls.

(a) Apply only to issuers (but an issuer's books and records include those of its consolidated subsidiaries and affiliates under its control, including foreign subsidiaries and joint venture partners).

(b) Do not apply merely because a fund is registered with the SEC, so they are usually not an issue for private investment funds. However, they do apply to portfolio companies that are publicly traded, whether in equity or debt markets.

[59] *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.).

[60] While the FCPA only prohibits the bribery of foreign officials, bribery in the private sector may violate other laws, such as: the Travel Act (18 U.S.C. § 1952), the U.S. mail and wire fraud statutes (18 U.S.C. §§ 1341, 1343, 1346), commercial bribery laws, the United Nations Convention Against Corruption (Dec. 11, 2003, 43 I.L.M. 37), among others. Other countries and international orgnizations also have tough anti-bribery laws, such as the Cayman Islands; the United Kingdom; the EU; OAS; World Bank; IMF; OECD Convention on Combating Bribery of Foreign Officials in International Business Transactions.

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B. The DOJ and SEC enforce the FCPA; penalties are harsh.

1. Criminal penalties for the anti-bribery provisions: Corporate fine up to $2 million for each violation. Individuals (officers, directors, employees, agents, etc.) can be fined up to $250,000 and imprisoned up to five years for each violation.[61] Fines can also be up to twice the profit gained from the illegal activity or twice the loss resulting from the illegal activity.

2. Criminal penalties for violating the accounting provisions: corporate fine up to $25 million and individuals up to $5 million and/or 20 years in prison.

3. Civil penalties for violating the anti-bribery provisions may include DOJ and/or SEC obtaining injunctive relief and fines up to $10,000 for each violation ($16,000 adjusted for inflation).

4. Civil penalties for violating the accounting provisions may include hefty fines imposed by the SEC or disgorgement of illegal profits.

5. Other adverse consequences include forfeiture of assets, suspension or disbarment from the securities industry or from contracting with the federal government, cross-debarment by multilateral development banks, the suspension or revocation of certain export privileges, shareholder derivative and class action lawsuits, plus other collateral consequences.

6. Rewards and protections are available under whistleblower provisions of the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Act of 2010. The SEC received more than 4,000 whistleblower tips in FY2016, of which 238, or 5.6 percent, involved FCPA allegations.

C. Anti-bribery provisions make it illegal for an "issuer," a "domestic concern" or any "other" person to make corrupt payments, directly or indirectly, to a foreign government official in order to obtain, retain or direct business. 15 U.S.C. §§ 78dd-1 to -3.

1. "Issuer" is any entity with a class of securities registered under the Securities Exchange Act of 1934, including foreign companies with U.S. ADRs.

2. "Domestic concern" means U.S. citizens, nationals and residents as well as companies that have their principal place of business in the United States or are organized under U.S. law.

3. "Other person" means a non-U.S. person, who may be liable if they commit any act in furtherance of an unlawful payment while in the territory of the United States ("territorial jurisdiction"), including (according to the DOJ) "causing" an act in the United States, directly or through agents.

4. Other jurisdictions also have anti-bribery laws, such as the Cayman Islands Anti-Corruption Law. The U.K. Bribery Act, for example, applies to conduct on or after July 1, 2011 by persons subject to the authority of the U.K. Serious Frauds Office ("SFO"). In the few cases under this recent law, penalties are severe.[62]

5. For example, in early 2016, a U.K. construction company was sentenced and ordered to pay £2.25 million after it was convicted under a provision that makes a corporation liable for an "associated person's" act of bribery where a subsidiary made payments (perhaps without the parent's knowledge) to secure a contract in Abu Dhabi. The sentencing judge stated that "The whole point

[61] Fines on individuals cannot be paid by the corporation. 15 U.S.C. § 78dd-2(g)(3).

[62] *See generally* Serious Frauds Office, The Bribery Act 2010 Guidance (Mar. 2011), *available at* www.justice.gov.uk/downloads/legislation/bribery-act-2010-guidance.pdf.

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of section 7 is to impose a duty on those running such companies throughout the world properly to supervise them."[63]

6. Nonetheless, bribery including "facilitation payments" to obtain or speed up a legally required act were illegal before the U.K. Bribery Act. For example, a small family-run printing company and two of its officers were convicted and fined for corrupt payments both pre- and post-2011 under the Prevention of Corruption Act of 1906.[64]

D. Certain persons can be held liable even though they are not directly involved in the violations:

1. U.S. parents may be held liable for acts of foreign subsidiaries if they participated in or directed the illegal activity, or, under agency principles, if the requisite degree of control exists over the subsidiary's actions.

2. Related persons (i.e., officers, directors, employees or agents of a U.S. issuer or domestic concern or a covered non-U.S. company, or any stockholder acting on their behalf).

3. Under the "control person" theory of liability of § 15 of the Securities Act of 1933 (15 U.S.C. § 77o) and § 20(a) of the Securities Exchange Act of 1934 (15 U.S.C. § 78t(a)), the SEC can impose liability for a securities law violation not only on the person who actually committed the violation but also on an entity or individual that "controls" the violator (directly or indirectly, via stock ownership, agency, or otherwise).[65] Control person liability creates potential exposure for investment funds and their personnel to the extent they exercise control over a portfolio company that is a U.S. issuer by virtue of ownership interest, board representation, and/or involvement in management and financial reporting. For example, a private investment fund that controlled a U.S. issuer that engaged in FCPA violations could face liability under this theory.

E. Elements of an FCPA Violation

1. Payment or offer of money or "anything of value" (no monetary threshold). An offer, promise or authorization of a payment is enough to violate the FCPA, even if no payment has yet been made.

2. Prohibited Recipient

(a) "Foreign official" (i.e., "[a]ny officer or employee of a foreign government or any department, agency or instrumentality thereof, or any person acting in an official capacity for or on behalf of any such government or department, agency or instrumentality"). According to the DOJ/SEC, the instrumentality prong includes employees of state-owned entities or state-controlled entities ("SOEs"), even those SOEs are engaged in commercial activities.[66]

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[63] Press Release, Serious Frauds Office, Sweett Group PLC sentenced and ordered to pay £2.25 million after Bribery Act conviction (Feb. 19, 2016), *available at* www.sfo.gov.uk/2016/02/19/sweett-group-plc-sentenced-and-ordered-to-pay-2-3-million-after-bribery-act-conviction.

[64] Press Release, Serious Fraud Office, UK printing company and two men found guilty in corruption trial (Dec. 22, 2014)*, available at* www.sfo.gov.uk/2014/12/22/uk-printing-company-two-men-found-guilty-corruption-trial; David Connett, Landmark corruption fine levied against Smith and Ouzman, Independent (Jan. 8, 2016), *available at* www.independent.co.uk/news/business/news/landmark-corruption-fine-levied-against-smith-and-ouzman-a6803526.html.

[65] E.g., *SEC v. Nature's Sunshine Products, Inc., Douglas Faggioli and Craig D. Huff*, Case No. 09CV672 (D. Utah, Filed July 31, 2009) (the SEC charged two top executives of a U.S. issuer, in their capacity as control persons, with books and records and internal control violations — the SEC's theory was that the CEO and CFO failed to adequately supervise Nature's Sunshine personnel).

[66] According to the DOJ/SEC, whether a particular entity constitutes an "instrumentality" under the FCPA requires a fact-specific analysis of an entity's ownership, control, status and function. A non-dispositive and non-exclusive list of factors to consider includes: "(1) the foreign state's extent of ownership of the entity; (2) the foreign state's degree of control over the entity (including whether key officers and directors of the entity are, or are appointed by, government officials); (3) the foreign state's characterization of the entity and its employees; (4) the circumstances surrounding the entity's creation; (5) the purpose of the entity's activities; (6) the entity's obligations and privileges under the foreign state's law; (7) the exclusive or controlling power vested in the entity to administer its designated functions; (8) the level of financial

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(b) Officials of a “public international organization” (e.g., UN, World Bank).

(c) Foreign political parties, their officials and candidates for foreign political office.

(d) Any person acting as a conduit for payments to any of the above.

3. Corrupt intent, meaning the payment must be for the purpose of influencing any act or decision of a foreign official in his or her official capacity; inducing the foreign official to do or omit to do any act in violation of the lawful duty of such official; securing any improper advantage; or inducing the foreign official to use his or her influence with a foreign government or instrumentality to affect or influence any act or decision of such government or instrumentality.

4. Business Purpose Requirement: Payment must be made for the purpose of assisting the violating party in obtaining or retaining business for or with, or directing business to, any person. That business does not need to be with a foreign government or foreign government instrumentality.

5. Jurisdiction

(a) U.S. issuers, U.S. companies and U.S. individuals liable for prohibited acts committed anywhere in the world, regardless if there is a nexus to the United States.

(b) Non-U.S. persons liable (as noted above) for prohibited acts committed while in the territory of the United States (“territorial jurisdiction”), including (according to the DOJ) “causing” an act in the United States.

F. Enforcement is increasing.

1. The DOJ and the SEC have dramatically increased enforcement efforts in recent years. While only four fines in the FCPA’s first 25 years exceeded $1 million, eight- and nine-digit fines are common today. The largest settlement was for $800 million by Siemens.

2. Brazilian construction company Odebrecht and its subsidiary Baskem S.A. pleaded guilty and agreed to pay a total of $3.5 billion to the DOJ, the SEC, and Brazilian and Swiss authorities in connection with millions of dollars of corrupt payments over the span of eight years to influence the state-owned energy company Petrobras. The actual amount it must pay will be determined at sentencing in April.[67]

3. Israeli pharmaceutical Teva pleaded guilty and agreed to pay $519 million to the DOJ and the SEC in connection with alleged corrupt payments in Russia, Ukraine and Mexico. The complaint charged that Teva lacked international controls necessary to prevent and detect the payments, which had been classified as payments to distributors. The sum to be paid to the SEC is $236 million in

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support by the foreign state (including subsidies, special tax treatment, government-mandated fees and loans); (9) the entity’s provision of services to the jurisdiction’s residents; (10) whether the governmental end or purpose sought to be achieved is expressed in the policies of the foreign government; and (11) the general perception that the entity is performing official or governmental functions.” While the DOJ/SEC have provided guidance that “an entity is unlikely to qualify as an instrumentality if a government does not own or control a majority of its shares,” DOJ/SEC enforcement actions have, in limited circumstances, involved foreign officials employed by SOE in which a foreign government has less than 50 percent ownership (i.e., only where the foreign government has “substantial control” over the SOE at issue).

[67] Richard L. Cassin, DOJ and SEC take small slice of Odebrecht-Braskem $3.5 billion global settlement, FCPA Blog (Dec. 21, 2016 1:18 pm), *available at* www.fcpablog.com/blog/2016/12/21/doj-and-sec-take-small-slice-of-odebrecht-braskem-35-billion.html.

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disgorgement, based on the $214 million in profit the SEC alleged Teva gained through regulatory approvals illicitly obtained with the payments.[68]

4. As in other areas, the DOJ continues to express its interest in pursuing individuals and its intent to hold them criminally liable for corporate misdeeds. Indeed, the government's focus on individual liability in criminal cases was publicly announced in September 2015 when the DOJ issued a memorandum written by Deputy Attorney General Sally Quillan Yates entitled "Individual Accountability for Corporate Wrongdoing."[69] The memorandum trumpeted the government's intention to prosecute more individuals generally in white-collar cases. Most significantly, the memorandum requires that companies, funds and other entities identify to the government the individual executives, leaders, managers and employees who many have engaged in wrongdoing.

5. The impact of the Yates Memorandum on FCPA enforcement is still being quantified. 78 percent of individuals charged with FCPA criminal offenses since 2000 were charged in 2008 or later.[70] Recently, five individuals including the owner of several U.S.-based energy companies pleaded guilty to FCPA and other charges for paying bribes to the state-owned Venezuelan energy company and then laundering bribes through the United States.[71]

6. It is too early to say what the new administration holds, but in the months since the election, the Obama administration DOJ has issued a spate of subpoenas to gather documents and other evidence.[72]

G. Ways to Mitigate FCPA Risk

1. Fund Level

(a) Commitment from senior management ("tone from the top" against corruption).

(b) An effective code of conduct with written policies and procedures that are periodically updated (should address: gifts and entertainment expenses, retention of and dealings with agents/third-party intermediaries, facilitation payments, political and charitable contributions).

(c) Designation of an FCPA compliance officer with: (a) direct reporting to and oversight by senior management; (b) autonomy in decision-making; and (c) adequate resources.

(d) A risk-based approach tailored to the organization's specific needs and challenges (each fund's compliance program should be commensurate with the nature and extent of its interaction with foreign government officials).

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[68] Press Release, SEC, Teva Pharmaceutical Paying $519 Million to Settle FCPA Charges (Dec. 22, 2016), *available at* www.sec.gov/news/pressrelease/2016-277.html.

[69] Memorandum, Salley Quillan Yates, Deputy Attorney General, Individual Accountability for Corporate Wrongdoing (Sept. 9, 2015), available at www.justice.gov/dag/file/769036/download.

[70] *See,* DOJ, FCPA Enforcement Actions (Nov. 23, 2016), *available at* www.justice.gov/criminal-fraud/chronological-list.

[71] Press Release, DOJ, Miami Businessman Pleads Guilty to Foreign Bribery and Fraud Charges in Connection with Venezuela Bribery Scheme (Mar. 23, 2016), *available at* www.justice.gov/opa/pr/miami-businessman-pleads-guilty-foreign-bribery-and-fraud-charges-connection-venezuela.

[72] For example, back in 2012, Donald Trump criticized the FCPA as a hindrance to the competitiveness of U.S. businesses' foreign operations in countries like Mexico and China when asked about the investigations into Wal-Mart and its affiliates for alleged improper payments. Mike Koehler, Donald Trump: The FCPA Is a "Horrible Law and It Should Be Changed," FCPA Professor (Aug. 6, 2015), *available at* http://fcpaprofessor.com/donald-trump-the-fcpa-is-a-horrible-law-and-it-should-be-changed.

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(e) Training and certifications for all directors, officers, relevant employees, and, where appropriate, agents and business partners.

(f) Clear incentives (i.e., positive measures to drive complaint behavior and negative disciplinary measures to deter unethical/unlawful behavior).

(g) Third-party due diligence.

(h) Confidential reporting and internal investigations.

(i) Continuous improvement via periodic testing and review.

2. Portfolio Investment Level

(a) Risk assessment (key factors include: extent of the company's interaction with foreign governments; use of agents/third-party intermediaries; operating in high-risk jurisdictions).

(b) Review of target's FCPA/anti-bribery compliance program (if it has one).

(c) Examination of agent/consultant relationships (vetting third-party intermediaries via due diligence, approval requirements, documentation).

(d) Background checks on principals.

(e) Questions regarding any FCPA/anti-bribery issues, investigations, etc.

(f) FCPA contractual representations and warranties by third-party intermediaries, including full compliance (no materiality threshold), no financial interest on part of government official and termination rights.

3. Ongoing FCPA compliance for portfolio companies, beginning with establishing a compliance program if one doesn't exist and then ensuring that the program has elements appropriate for the nature of business (e.g., written policies and procedures, FCPA compliance officer, training of employees, employee certifications, due diligence on third-party intermediaries, periodic testing).

4. FCPA Opinion Procedure

Though infrequently used, a party can request a DOJ opinion as to whether certain prospective conduct, such as proposed business ventures involving foreign officials, violates the FCPA. DOJ reviews and must issue an opinion within 30 days after a request is deemed complete. Some of these opinions have addressed the extent of an acquirer's liability for the target's FCPA violations.[73]

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[73] Opinion Procedure Release 2003-01 (A U.S. Issuer [Acquirer] sought to purchase the stock of Company A, a U.S. company with domestic and foreign subsidiaries [Target]). During due diligence, Acquirer discovered payments made by Target to individuals employed by foreign state-owned entities. Both companies commenced parallel investigations of Target's activities around the world and disclosed the findings to the government. Pre-acquisition, Acquirer encouraged Target to undertake remedial measures and Acquirer promised DOJ it would implement numerous post-acquisition measures after becoming the owner of Target. DOJ stated that it did not intend to take any enforcement action against the Acquirer for the pre-acquisition conduct of the Target.

Opinion Procedure Release 2004-02 (An Investment Group [Acquirer] sought to acquire certain companies and assets from ABB Ltd. [Target] relating to its upstream oil, gas and petrochemical business). Prior to acquisition, Acquirer and Target agreed to conduct an extensive FCPA compliance review (involving a five-year look-back period, several forensic accountants, 115 lawyers billing over 44,700 man-hours, document review of millions of pages, 165 interviews of employees and agents, visits to 21 countries, 100 staff members, 22 analytical reports and everything was shared with the government). DOJ stated that it did not intend to take any enforcement action against the Acquirer or the recently-acquired Target entities for pre-acquisition conduct.

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5. FCPA Liability in the Context of Mergers and Acquisitions[74]

(a) When a company merges with or acquires another company, the successor company assumes the liabilities of the predecessor company, including FCPA violations, regardless of whether it knows about them.

(b) According to *A Resource Guide to the FCPA*, a 2012 publication by the DOJ and SEC, those law enforcement agencies have only taken action against successor companies in limited circumstances — generally, in cases involving egregious and sustained violations or where the successor company directly participated in the violations or failed to stop the misconduct from continuing after the acquisition.

(c) The government expects acquiring companies to conduct risk-based FCPA due diligence on prospective targets and to take appropriate steps if an actual or potential violation is identified in the course of due diligence.

(d) According to the guide, the DOJ and SEC encourage companies engaging in mergers and acquisitions to take the following actions and "will give meaningful credit to companies who undertake these actions, and, in appropriate circumstances, … may consequently decline to bring enforcement actions."

(i) Conduct thorough risk-based FCPA and anti-corruption due diligence.

(ii) Ensure that the acquiring company's code of conduct and compliance policies/procedures apply as quickly as possible to newly acquired businesses or merged entities.

(iii) Train the directors, officers and employees of newly acquired businesses or merged entities and, when appropriate, train agents and business partners.

(iv) Conduct an FCPA-specific audit of all newly acquired or merged businesses as quickly as practicable.

(v) Promptly disclose any corrupt payments that are discovered.

Opinion Procedure Release 2008-02 (A U.S. Issuer, Halliburton Company [Acquirer] bid to acquire the entire share capital of an oil and gas services company that was based in the United Kingdom and traded on the London Stock Exchange [Target]). Because of particular restrictions in U.K. law regarding the bidding process for a public company, Acquirer had insufficient time and inadequate access to information to perform robust pre-acquisition due diligence. Thus, Acquirer sought an opinion from DOJ and submitted a detailed, post-closing plan with strict deadlines for post-acquisition due diligence and remediation related to Target. DOJ stated that it did not intend to take any enforcement action against the Acquirer for: (1) acquisition of the Target, reasoning that the funds contributed as part of this corporate combination transaction could not be considered a "payment" that is "in furtherance of" a bribe given that the Target was publicly listed on a major exchange with a majority of its shares held by large, institutional investors; (2) any pre-acquisition conduct by the Target disclosed to the DOJ during the 180-day period following the closing; and (3) any post-acquisition violations committed by the Target during the 180-day period after closing, provided that the Acquirer disclosed and remediated any illicit conduct.

[74] *See also,* Gary Stein & Jared Wong, FCPA Due Diligence in Mergers and Acquisitions (Lexis/Nexis 2016).

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State of the Law and Practice: Insider Trading

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Barry is co-chair of Schulte Roth & Zabel's White Collar Defense & Government Investigations Group. Barry has extensive litigation experience handling white collar criminal and complex civil matters in federal and state courts for individual and corporate clients. He also has an active trial and appellate practice. Barry has successfully defended clients, including major corporations, financial institutions, political figures, corporate executives and individuals, professionals and prominent law firms, in a wide variety of high-profile and complex cases, jury trials, regulatory actions and investigations. He regularly represents clients in matters pertaining to securities and commodities litigation and regulatory enforcement; other forms of financial fraud; antitrust litigation; and allegations of environmental offenses. He frequently represents clients in parallel enforcement proceedings involving the U.S. Department of Justice, the Securities and Exchange Commission and the Commodity Futures Trading Commission. He also conducts corporate internal investigations and counsels individuals involved in them. In his appellate practice, Barry has won appeals at all levels of the federal and state court systems throughout the nation, and is retained in high-stakes appellate cases where he is brought in by other legal teams specifically for his appellate proficiency.

Barry has been named a leading litigation, white collar criminal defense and investigations lawyer by *Benchmark Litigation: The Definitive Guide to America's Leading Litigation Firms and Attorneys*, *The Best Lawyers in America*, *Chambers USA*, *Expert Guide to the Best of the Best USA*, *Expert Guide to the World's Leading White Collar Crime Lawyers*, *The Legal 500 United States*, *New York's Best Lawyers*, *New York Super Lawyers, Who's Who Legal: Business Crime Defence* and *Who's Who Legal: Investigations*. In 2014, Barry received The Norman S. Ostrow Award from the New York Council of Defense Lawyers in recognition of his outstanding contributions as a defense lawyer. He was the author of the "White Collar Crime" column in the *New York Law Journal* from 2002 to 2013 and is on the board of editors of the *White Collar Crime Reporter*. He speaks frequently on various topics, including issues relating to trial and appellate practice, securities enforcement and arbitration, internal investigations and insider trading. Barry is a Fellow of the American College of Trial Lawyers, former president of the New York Council of Defense Lawyers, and chair of the board of directors of the Fund for Modern Courts and Committee for Modern Courts, non-profit organizations dedicated to judicial reform in New York State. He is a member of the board of directors of the Legal Aid Society (chairman of the Audit Committee) and received awards in 2005 and 2006 for Outstanding Pro Bono Service for his advocacy. He is also a member of the New York City Bar Association (former member of the Criminal Law Committee) and the New York State and American Bar Associations (Criminal Justice and Litigation Sections), and he serves on the advisory boards of Bloomberg BNA's *The Criminal Law Reporter* and *White Collar Crime Report*.

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Charles represents financial institutions, public companies and accounting firms, and their senior executives, in securities-related enforcement proceedings before the SEC, DOJ, FINRA, CFPB, and other federal and state law enforcement and regulatory authorities. In particular, he counsels hedge funds, private equity firms, venture capital funds and other asset managers through regulatory scrutiny, including in routine and risk-based inspections and examinations and in enforcement proceedings. He defends investigations involving a broad spectrum of issues, including accounting and disclosure fraud, insider trading, foreign corruption, offering fraud, market manipulation, breach of fiduciary duty and conflicts of interest. In addition, Charles represents boards of directors and associated committees in internal investigations, and he provides guidance on corporate governance and trading practices for public companies and private funds. Prior to entering private practice, Charles served for nine years in the SEC's Division of Enforcement, most recently as assistant director supervising the investigation and prosecution of some of the SEC's most significant matters, including its investigation of Enron Corporation.

Charles is recognized as a leading litigator by *Chambers USA* and *The Legal 500 United States*. A frequent speaker and panelist, he has addressed 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. Charles also contributed the "Use of Paid Consultants" chapter in the *Insider Trading Law and Compliance Answer Book* (Practising Law Institute). He serves as a resource for numerous media publications, including *Bloomberg News*, *Financial Times*, *The Wall Street Journal* and *The Washington Post*.

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Doug represents clients in high-profile civil and criminal proceedings, as well as investigative matters. Doug is best known for supervising these types of matters for financial institutions and broker-dealers as well as representing executives in the crosshairs of the government regulators and criminal authorities. Doug has been actively engaged in cases involving financial service institutions, broker-dealers and corporate executives relating to securities, derivative products and other complex financial instruments. In this regard, he has advised and defended companies and corporate executives in virtually all types of inquiries by civil and criminal authorities (as well as SROs) into business practices on Wall Street, including a wide array of matters involving the financial crisis. He has also handled major civil litigations and arbitrations involving a broad spectrum of substantive legal issues, including fraud, breach of contract, antitrust, breach of fiduciary duty, reinsurance, piercing the corporate veil, mergers and acquisitions, and money laundering, as well as federal securities law.

Doug has been recognized as a leading lawyer by *Chambers USA*, which noted that he is “hard working, attentive and client-focused” and “a smart, thorough litigator who is always on top of things.” *Chambers* also noted that he “has everything on his radar screen” and has a “remarkable ability to get along with anyone, making it his business to develop a rapport with other attorneys involved in his cases.” He has spoken and written widely on key industry topics, including current trends in financial regulation and enforcement and securities laws violations.

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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 has spoken on topics including insider trading, SEC examinations and compliance issues for private investment funds.

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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. Recently, he won dismissal on statute of limitations grounds in the U.S. Court of Appeals for the Second Circuit for The Royal Bank of Scotland Group, as successor to National Westminster Bank PLC, of a suit brought by investors alleging fraud in connection with loans related to a tax shelter scheme known as Bond Linked Issue Premium Structure, or BLIPS. He also obtained victories in other significant matters, including prevailing in a price adjustment case involving the dispute of several $100 million for a portfolio of real estate mortgages. 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 "Washington's 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*, *Benchmark Litigation: The Definitive Guide to America's Leading Litigation Firms and Attorneys*. Noted for being a "committed and effective advocate" by *Chambers USA*, 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. Howard is the author of the "Tipper and Tippee Liability" chapter in the *Insider Trading Law and Compliance Answer Book* (Practising Law Institute). He recently presented on ethical issues for general counsels and chief compliance officers and trading-related compliance and enforcement activities.

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State of the Law and Practice: Insider Trading

I. Insider Trading Overview

A. Over the past decade, federal prosecutors and the SEC have been cracking down on insider trading and what they perceive to be a systemic abuse.

B. Insider trading is investigated and prosecuted on the civil regulatory side by the SEC, and on the criminal side by the Department of Justice and the various U.S. Attorneys' offices around the country.

1. Civil Liability

(a) Proof of a "reckless state of mind" is sufficient scienter for liability.

(b) Proof must be by a preponderance of evidence (51-percent likelihood).

2. Criminal Liability

(a) Proof of a "criminal intent" (knowledge) is required for liability.

(b) Proof must be beyond a reasonable doubt.

II. Elements of Insider Trading

A. Element 1: Trading in a security;

B. Element 2: On the basis of material nonpublic information (MNPI) relating to the issuer;

C. Element 3: That was secured in breach of a fiduciary duty or a duty of trust or confidence owed to the issuer and its shareholders, or any other source of nonpublic information.

III. Element 1: Trading in a Security

A. The term "security" is broadly defined. There is no requirement that securities be publicly traded on an exchange. Courts have routinely found insider trading to exist in privately traded securities.

B. Some examples of securities:

1. Equity interests (common and preferred stock, partnership interests, membership interest in LLC)

2. Debt instruments (notes, bonds, convertible debt)

3. Warrants

4. Options

5. Futures

6. Derivatives

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IV. Element 2: Trading on the Basis of Material Nonpublic Information

A. Trading "on the basis of" differs in the civil and criminal contexts:

1. Civil

(a) Section 10b5-1 provides that in SEC actions if someone makes a trade while in possession of information, the trade is "on the basis of" that information.

"Subject to the affirmative defenses in paragraph (c) of this section, a purchase or sale of a security of an issuer is 'on the basis of' material nonpublic information about that security or issuer if the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale."

(b) However, the trade is not "on the basis of" such information if:

(i) Before coming into possession of the information the person had contracted to, given instructions to someone else to, or adopted a written plan to sell or purchase the securities;

(ii) Such contract, instructions or plan either specify the amounts and price for the trade, include a formula or algorithm for calculating amounts and price, or did not grant the person any subsequent influence over the amounts or price; and

(iii) The trade occurred pursuant to the contract, instructions or plan.

2. Criminal

Circuit courts are split on whether the "knowing possession" or "use" standard applies in the criminal context.

(a) The Ninth Circuit has held that "knowing possession" is not enough; there must also be "use." E.g., *United States v. Smith*, 155 F.3d 1051 (9th Cir. 1998).

(b) The Second Circuit has explicitly endorsed the "knowing possession" standard in criminal insider trading cases. E.g., *United States v. Teicher,* 987 F.2d 112 (2d Cir. 1993).

(i) In *United States v. Rajaratnam,* the Second Circuit affirmed the use of a "knowing possession" standard and upheld the conviction of Galleon founder Raj Rajaratnam. 719 F.3d 139, 157-161 (2d Cir. 2013).

The court found that the district court's instruction to the jury — that it could convict if the nonpublic information Rajaratnam obtained was "a factor, however small" in his decision to trade stock — was proper.

(ii) Three Second Circuit cases, including *Rajaratnam*, have held that "knowing possession" is enough. However, the jury charges in these cases did not use the "knowing possession" standard and instead relied on actual use.

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B. "Material"

1. Material information is information that a reasonable investor would find important in making an investment decision within the particular context of the purchase and sale of a security.

   Materiality has also been described as information that a reasonable investor would believe alters significantly the total mix of publicly available information.

2. Materiality does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused a reasonable investor to trade in the security.

3. Materiality is determined in hindsight.

   The "mosaic theory" of insider trading is sometimes invoked to argue that certain nonpublic information is not material.

   (a) The "mosaic theory" involves putting together many disparate pieces of data that individually are not material, but when put together, provide a valuable informational edge.

   (b) While putting together a "mosaic" may be more akin to research, not insider trading, the line between immaterial nonpublic information and material nonpublic information is vague and can be hard to draw.

C. "Nonpublic Information"

Information is nonpublic if it was not available to the public through sources such as press releases, SEC filings, trade publications, analyst reports, newspapers, magazines, television, radio or word of mouth.

1. If the information is not generally available, and the owner would not make it available in response to a request, then it is nonpublic rather than public.

2. Because the reliability of rumors or press reports is sometimes difficult to evaluate, a trier of fact may find that information obtained from a particular insider, even if it mirrors rumors or press reports, is sufficiently more reliable to render it material and nonpublic.

V. Element 3: Breach of a Duty

A. To constitute a deceptive act under the securities laws, the trading must be in breach of a duty of trust or confidence.

Courts have explained this duty in the context of the three theories of insider trading. Although each theory focuses on a different category of trader, each premises liability on trading in a security on the basis of MNPI by one who violates a duty by making the trade.

B. Trading on the basis of MNPI concerning a tender offer, which is governed by SEC Rule 14e-3, is prohibited whether or not the MNPI was obtained in breach of a duty of trust or confidence.[1] For the rule to apply, MNPI about a tender offer must be received directly or indirectly from someone involved in the tender offer, such as a person engaging in the tender offer, the issuer of the subject securities or any officer, director, partner, employee or other person acting on behalf of either the offering person or the issuer.

[1] *See* Section 14(e) of the Exchange Act and SEC Rule 14e–3.

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C. Classical Theory

A corporate insider is liable for insider trading if he or she trades in a security based on MNPI:

1. The insider must owe a duty of confidentiality to the corporation.

2. "Insiders" include:

   (a) Officers, directors or employees of a company; and

   (b) "Temporary insiders," such as attorneys, accountants and other outside service providers who temporarily assume a fiduciary duty to the company.

D. Misappropriation Theory

1. An individual may be liable for insider trading if he or she:

   (a) Has a relationship of trust and confidence with the owner of certain business information; and

   (b) As a result of that relationship, was entrusted with information with the reasonable expectation that he would keep it confidential and would not use it for his personal benefit.

2. Relevant Question: Did the owner of the information expect the individual to keep that information confidential and to refrain from improperly disclosing it?

   (a) The owner of the information need not be the issuer of the security traded. For example, the information can be knowledge of a nonpublic press report that belongs to a media company or a pending change in a research rating that belongs to a broker-dealer.

   (b) This expectation need not have been expressed explicitly or in writing. It may be inferred from the nature and circumstances of the relationship between the individual at issue and the owner of the business information at issue.

3. Rule 10b5-2 provides some guidance on the types of circumstances that could give rise to a duty of trust or confidence. Those circumstances include:

   (a) Whether a person agreed to maintain information in confidence;

   (b) Whether the parties have a history, pattern or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the information expects the recipient to maintain its confidentiality; and

   (c) Whether a person received or obtained information from his or her spouse, parent, child or sibling.

   (d) *SEC v. Cuban*

      (i) In 2009, the Northern District of Texas rejected Rule 10b5-2(b)(1) as an inappropriate extension of the SEC's authority and held that an agreement not to disclose confidential information by itself was insufficient to establish liability. 634 F. Supp. 2d 713 (N.D. Tex. 2009).

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(ii) The court reasoned that an agreement not to disclose is sufficient to establish insider trading only if it also contains a promise by the noninsider to "refrain from trading" on the information.

(iii) In September 2010, the Fifth Circuit vacated the district court's decision and reinstated the charges, holding that the complaint contained adequate allegations that Cuban had agreed both not to disclose and not to trade on the information. *SEC v. Cuban*, 620 F.3d 551 (5th Cir. 2010).

(iv) The Fifth Circuit did not address whether Rule 10b5-2(b)(1) is valid.

(v) The district court denied Cuban's motion for summary judgment and the case proceeded to jury trial in 2013. At trial, Cuban won on all counts. The jury found that the information Cuban acted on was not confidential and that he had not promised not to trade on it.

E. Tipper/Tippee Theory

1. Both the classical and misappropriation theories extend to cases in which the "insider" or misappropriator does not personally trade, but reveals MNPI to another person who does trade.

(a) For the tipper to be liable, it must be established that the tipper disclosed MNPI in breach of a fiduciary duty of confidentiality owed to shareholders (classical theory) or the source of the information (misappropriation theory) for a personal benefit.

The personal benefit need not be financial. It includes the "gift of information" to family and friends, currying favor with a supervisor and reputational benefits.

(b) Tippees can be held liable only if the tipper breaches a duty by tipping the MNPI, and the tippee knew or should have known that the tip constitutes a breach.

2. In 2014, the Second Circuit held in *United States v. Newman* that the tippee must have knowledge that the tipper is receiving a personal benefit. It also stated that sufficient proof of receipt of a personal benefit requires a showing of a potential gain of a pecuniary or similarly valuable nature.

(a) Potential implications of the *Newman* decision:

(i) *Newman* arguably made it more difficult for the government to prosecute remote tippees and shifts the focus to insiders and tippees involved in the initial disclosure of confidential information.

(ii) Although *Newman* involved criminal liability, it could also limit the SEC's ability to bring civil enforcement actions against remote tippees.

(b) In October 2015, the Supreme Court denied the government's petition for certiorari of the Second Circuit's decision in *Newman*.

3. In December 2016, the Supreme Court affirmed the Ninth Circuit's decision in *United States v. Salman*, which made a deviation from *Newman*. The Court rejected the argument that the direct tippee's familial relationship with his tipper brother was insufficient to demonstrate a "potential gain" under *Newman*, and stated that to the extent that *Newman* could be read so broadly, the Ninth Circuit declined to follow it.

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It is important to note that this narrow holding does not address tipper-tippee liability outside the scope of trading relatives and friends. Although the Supreme Court's decision in *Salman* is important, it is also important to recognize that *Salman* does not cast doubt on the Second Circuit's reversal of the two hedge fund traders' convictions in *Newman* or arguably the most consequential holding of *Newman*, that a remote tippee must know that the tipper received a personal benefit in exchange for the tip.

VI. Insider Trading Law Enforcement Techniques

A. Conventional law enforcement methods include:

1. Obtaining records, such as telephone records, bank records, brokerage statements, trading records, e-mails, instant messages, historical trading patterns and analyst reports.

2. Requests to broker-dealer firms to provide chronologies, lists of deal team members, calendars and other documents that identify the who, what, where and when of a transaction.

3. Using experts to ascertain reasons for movement in stock prices and volume. The government looks not only at trades in individual stocks, but trades in whole industries or sectors that could be affected by certain information, particularly where "expert networks" are involved in providing industry information to hedge funds.

4. Social media such as Facebook, LinkedIn, MySpace and other social networks can be a fertile source of information about relationships among people.

5. Credit cards, cellphones and MetroCards can be sources of information about the whereabouts of people. MetroCard swipes by a tipper and tippee, for example, in the same subway turnstile seconds apart have been used to show their location in the same place at the same time.

B. Wiretap Evidence

1. Historically, the use of wiretap evidence was limited to the prosecution of "predicate" crimes specifically enumerated in Title III of the Omnibus Crime Control and Safe Streets Act of 1968. *See* 18 U.S.C. §2510, *et seq*. The evidence was admitted primarily in drug cartel, alien smuggling and organized crime cases.

2. Recently, federal courts have upheld the use of wiretap evidence several times in insider trading prosecutions. *See,* e.g., *United States v. Rajaratnam*, 802 F. Supp. 2d 491 (S.D.N.Y. 2011). The Second Circuit again upheld the use of evidence obtained by wiretap in an offshoot of the *Rajaratnam* case. *See United States v. Goffer*, No. 11-CR-907, 2013 U.S. App. LEXIS 13388, at *1, *14-15, *17 (2d Cir. July 1, 2013).

   (a) The court held that the government may investigate offenses not enumerated in the Act so long as "there is no indication of bad faith or subterfuge by federal officials."

   (b) The court explained that the government's wiretap application indicated "that, in addition to wire fraud, they expected to uncover evidence of securities fraud (which, they expressly noted, is 'not a predicate offense') … . This representation ensured that the wiretaps were not obtained as a 'subterfuge' or to surreptitiously investigate crimes other than those about which they informed the court."

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C. In addition to using wiretaps, the FBI established the Financial Intelligence Center and the SEC has established an Office of Market Intelligence.

1. These offices use technological tools and screening programs to analyze trading and other activity across markets, and cross-reference that activity with public announcements and regulatory disclosures.

2. FINRA uses similar systems to identify suspicious trading patterns and match them to contemporaneous news, announcements and events.

D. There is also early cooperation between the SEC and the Department of Justice.

These offices work together to obtain records and conduct covert investigations targeted at insider trading.

1. The SEC and federal prosecutors gather evidence of bad acts to convince individuals to act as informants.

2. Informants are typically asked to wear, and do wear, wires to record conversations with the subjects of governmental investigations.

E. In many instances, the Department of Justice uses some of the information it obtained through covert investigations in order to apply for court-ordered wiretaps of telephones and emails, and court ordered bugs of offices, cars or residences.

VII. Consequences of Insider Trading

A. Civil

1. The SEC may seek disgorgement of up to three times any profits earned or any loss avoided.

2. Monetary penalties:

(a) For primary violators, penalties can be up to three times the profit gained or loss avoided.

(b) For control persons, penalties can be up to $1 million or three times the profit gained or loss avoided.

3. Individuals lose their jobs and may be barred against future employment in the securities industry.

4. Mere allegations of insider trading can put firms out of business through massive investor redemptions or withdrawals, losses of licenses and reputational damage.

B. Criminal

1. Defendants face up to:

(a) 20 years of imprisonment per count for violations charged under the Securities Exchange Act and fines of $5 million (individuals) or $25 million (organizations); and

(b) 25 years of imprisonment per count for violations charged under 18 U.S.C. §1348 (securities and commodities fraud) and criminal fines.

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2. The United States may also seek criminal forfeiture of profits in addition to restitution.

VIII. Insider Trading Controls

Supervisory Requirements/Controls

1. Section 15(g) of the 1934 Act requires registered broker-dealers to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of MNPI, taking into consideration the nature of each broker-dealer's business.

2. Section 204A of the Investment Advisers Act places similar obligations on registered investment advisers.

IX. Insider Trading Cases Brought/Decided in 2016

A. Charges/Cases Filed in 2016

In the Matter of Vivian S. Shields
Date: Jan. 4, 2016
Agency: SEC
Authority: Civil
Forum: SEC Administrative Proceeding
Event: Settled Administrative Order

Summary: According to the SEC, Shields allegedly engaged in insider trading on the basis of material nonpublic information by purchasing stock in advance of a positive news announcement regarding the acquisition of J. Alexander's Corporation. More specifically, the SEC alleged that, from May 29, 2012 to June 6, 2012, Shields purchased 12,600 shares of J. Alexander's Corporation stock while in possession of material nonpublic information relating to what was ultimately a tender offer for J. Alexander's by Fidelity National Financial Inc. Shields indirectly acquired the information from a J. Alexander's employee while the two were on a vacation together. During the vacation, the J. Alexander's employee had learned of the tender offer. On July 18, 2012, following a J. Alexander's press release that announced Fidelity's acquisition of J. Alexander's, Shields sold 1,000 shares of her J. Alexander's stock and tendered the remainder of her holdings in mid-September 2012. In total, Shields realized a profit of $71,401.12.

Status: On Jan. 4, 2016, Shields settled with the SEC. Pursuant to the terms of the settlement, Shields agreed to cease and desist from future violations. Shields also agreed to pay disgorgement of $71,401.12, prejudgment interest of $5,724.46 and a civil penalty in the amount of $71,401.12.

In the Matter of Reid A. Hackney, CPA
Date: Jan. 9, 2016
Agency: SEC
Authority: Civil
Forum: SEC Administrative Proceeding
Event: Settled Administrative Order

Summary: The SEC alleged that Hackney, chief financial officer and senior vice president of the Dress Barn subsidiary of Ascena Retail Group Inc., engaged in insider trading in advance of two public announcements on the basis of material nonpublic information he obtained from his employer. First, in January 2012, Hackney became aware of Ascena's positive holiday sales results and traded Ascena securities in advance of the public release of this information, realizing ill-gotten gains of $3,300. Two

months later, in March 2012, Hackney became aware, in the course of his employment, of Ascena's plans to acquire Charming Shoppes Inc. Hackney allegedly used his inside knowledge about Ascena's plans to acquire Charming Shoppes to purchase Charming Shoppes securities prior to the public announcement of the transaction. As a result, Hackney realized trading profits of $44,750.

Status: On Jan. 12, 2016, Hackney settled with the SEC. Pursuant to the terms of the settlement, Hackney can no longer appear or practice before the SEC as an accountant, and he is prohibited from acting as an officer or director of a public company for a period of five years. He also agreed to pay disgorgement of $48,050, prejudgment interest of $4,670 and a civil penalty of $48,050, for a total of $100,770.

SEC v. Munakash, et al.
Date: Feb. 5, 2016
Agency: SEC
Authority: Civil
Forum: U.S. District Court for the Central District of California (C.D. Cal.)
Event: Civil Complaint Filed; Settlement Reached with Rodriguez, Winters and Munakash

Summary: The SEC alleged that during a trip to the Super Bowl, Munakash learned from a close friend, an executive at GSI Commerce Inc. ("GSIC"), that GSIC was likely to engage in a strategic transaction with a private equity firm or be acquired by another company. Munakash allegedly used this information to purchase GSIC stock for his personal account and tipped both his mentee and employee, Carlos Rodriguez, and his registered representative, Marc Winters. Rodriguez used the information to purchase GSIC stock for himself and tipped a close relative, who also purchased GSIC stock. Winters used the information to first purchase GSIC stock for two discretionary client accounts and then to purchase GSIC stock for his personal account. Subsequently, Munakash learned additional information about the potential acquisition from his friend (a GSIC executive) a few weeks after the Super Bowl, during the executive's birthday dinner. The following day, Munakash used this information to purchase additional shares of GSIC stock in his parents' account and again tipped Rodriguez, who also purchased additional GSIC stock. Following the public announcement of GSIC's proposed acquisition by eBay Inc. on March 28, 2011, GSIC's stock price increased by over 51 percent. Munakash, Rodriguez and his relative, and Winters and his clients, all sold their respective positions in GSIC stock within hours of the announcement, realizing over $250,000 in ill-gotten gains.

Status: On June 6, 2016, Rodriguez consented to a judgment against him, agreeing to be permanently enjoined from future violations. Rodriguez also agreed to pay disgorgement plus prejudgment interest in the amount of $20,899.33 and to pay a $42,575.69 civil penalty, for a total of $63,475.02. On Dec. 2, 2016, Winters agreed to pay disgorgement of $4,103, prejudgment interest of $837 and a penalty of $31,944. Finally, on Dec. 7, 2016, Munakash agreed to pay disgorgement and prejudgment interest of $212,975 and a civil penalty in the amount of $200,907. Munakash also agreed to be permanently enjoined from future violations.

SEC v. Dennis W. Hamilton; United States v. Dennis W. Hamilton
Date: Feb. 5, 2016
Agency: SEC and DOJ
Authority: Joint Civil/Criminal
Forum: U.S. District Court for the District of Connecticut (D. Conn.)
Event: Parallel Civil and Criminal Proceedings Initiated; Guilty Plea Entered in Criminal Case

Summary: The SEC alleged that Hamilton, a former tax executive at Harman International Industries (an automotive audio and technology company), knew in October 2013 that his company would have a good first quarter in 2014. In his role as Harman's vice president of tax, Hamilton had reviewed Harman's

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earnings and learned the company would report stronger-than-expected results for its first quarter in 2014. Pursuant to that material nonpublic information, Hamilton purchased shares of Harman stock before Harman publicly released its financial results. Harman's stock price rose more than 12 percent on the news, and Hamilton reaped $131,958. In a parallel action, the DOJ announced criminal charges against Hamilton.

Status: On March 28, 2016, Hamilton pled guilty to insider trading in the criminal case against him. On Sept. 1, 2016, he was sentenced to a term of imprisonment of eight months, followed by one year of supervised release. Hamilton was also ordered to pay a $131,958 fine. On Aug. 30, 2016, the SEC filed an amended complaint, alleging that Hamilton obtained more than $977,000 in illicit profits from four additional instances of insider trading in the company's securities on the basis of material nonpublic information, bringing the total alleged illicit profits to over $1.1 million. On Sept. 6, 2016, the court scheduled a settlement conference to be held on Oct. 26, 2016. No settlement was reached. The current scheduling order stipulates for all discovery to be completed by Sept. 1, 2017 and dispositive motions filed by Oct. 1, 2017.

In the Matter of Jarrod L. Spector
Date: Feb. 9, 2016
Agency: SEC
Authority: Civil
Forum: SEC Administrative Proceeding
Event: Settled Administrative Order

Summary: According to the SEC, Spector allegedly traded in the securities of GSI Commerce Inc. in advance of the March 28, 2011 announcement that eBay Inc. had agreed to acquire GSI. On or about Feb. 24, 2011, Spector learned material nonpublic information about the acquisition of GSI from a friend, who was married to a GSI employee. A day later, Spector purchased out of the money GSI call options on the basis of the information he had received. After public announcement of the eBay acquisition of GSI, the market reacted significantly, with GSI's stock increasing approximately 50.6 percent. Spector subsequently exercised his GSI options contracts. Immediately thereafter Spector sold the shares he had purchased, garnering trading profits of $21,350.

Status: On Feb. 9, 2016, Spector agreed to cease and desist from future violations and also agreed to pay disgorgement of $21,350, prejudgment interest of $3,104 and a civil penalty in the amount of $21,350.

In the Matter of Abdallah Fadel
Date: Feb. 10, 2016
Agency: SEC
Authority: Civil
Forum: SEC Administrative Proceeding
Event: Settled Administrative Order

Summary: The proceedings arose out of insider trading by Fadel, who purchased securities of Whirlpool Corporation while in possession of material nonpublic information that he learned while employed at Whirlpool as a financial analyst. On three separate occasions, Fadel traded option contracts on Whirlpool's common stock prior to Whirlpool announcing its earnings to the public. When Fadel purchased the option contracts, he was aware of Whirlpool's financial results that were going to be announced to the public. Fadel then sold the option contracts after the market reacted to Whirlpool's public announcements, realizing illicit profits of more than $100,000.

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Status: On Feb. 10, 2016, Fadel agreed to cease and desist from future violations and also agreed to be barred from acting as an officer or director of any issuer. Further, Fadel agreed to pay disgorgement of $109,077, prejudgment interest of $17,259 and a civil penalty of $36,000, for a total payment of $162,336.

SEC v. Evgenii Zavodchiko, et al.
Date: Feb. 17, 2016
Agency: SEC
Authority: Civil
Forum: U.S. District Court for the District of New Jersey (D.N.J.)
Event: Civil Complaint Filed

Summary: The government charged multiple defendants with taking part in a scheme to profit from hacked nonpublic information about corporate earnings. The government alleged that Ukraine-based hackers Ivan Turchynov and Oleksander Ieremenko spearheaded the scheme by hacking into Marketwire LP, PR Newswire Association LLC and Business Wire, stealing more than 100,000 press releases for publicly traded companies before they were publicly issued over a period of five years. Many of the releases contained quarterly and annual earnings data. According to the SEC's complaint, the hackers transmitted the stolen data to multiple groups of traders in Russia, Ukraine, Malta, Cyprus, France and three U.S. states: Georgia, New York and Pennsylvania. In the SEC's action, the SEC alleged that Evgenii Zavodchiko, Extra Trading Company, Andrey Bokarev, Radion Panko, Green Road Corp., Natalia Andreeva Alepko, Solar Line Inc., Anton Maslov and Tarek Investors Inc. used this same nonpublic information to place illicit trades in stocks and options, reaping over $19.5 million in illicit profits. The traders charged (including Zavodchiko) were brokerage customers of Malta-based Exante Ltd., and engaged in their allegedly illegal trading through a brokerage account held in Exante's name. The traders also purportedly paid the hackers for the stolen information, either giving a flat fee or a percentage of the proceeds from the illegal trades.

Status: The case remains ongoing.

In the Matter of Nicholas A. Prezioso
Date: Feb. 19, 2016
Agency: SEC
Authority: Civil
Forum: SEC Administrative Proceeding
Event: Settled Administrative Order

Summary: The SEC found that Prezioso engaged in insider trading by trading in advance of three public announcements based on material nonpublic information he obtained while serving as assistant controller of the Dress Barn subsidiary of Ascena Retail Group Inc. In December 2011, Prezioso became aware of Ascena's strong holiday sales results. Prezioso subsequently traded Ascena securities in advance of the public release of this information and realized ill-gotten gains of $114,710. In February 2012, Prezioso also became aware of Ascena's positive sales results for its fiscal second quarter. Prezioso traded Ascena securities in advance of the public release of this information and realized ill-gotten gains of $71,334. In March 2012, Prezioso became aware of Ascena's plans to acquire Charming Shoppes Inc. Prezioso later traded Charming Shoppes securities before the public announcement of the transaction and realized ill-gotten gains of $76,432.

Status: On Feb. 19, 2016, Prezioso agreed to cease and desist from future violations and agreed to be barred from acting as an officer or director for any issuer. Prezioso also agreed to pay disgorgement of $262,476, prejudgment interest of $26,955 and a civil penalty of $131,238, for a total of $420,669.

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In the Matter of Craig N. Salamone; In the Matter of Patricia Zajick Meltzer et al.; In the Matter of Lawrence M. Gincel
Date: March 1, 2016
Agency: SEC
Authority: Civil
Forum: SEC Administrative Proceeding
Event: Settled Administrative Order

Summary: This matter involved insider trading by Craig N. Salamone, Patricia Zajick Meltzer, Daniel P. Meltzer and Donald C. Zajick in the securities of GSI Commerce Inc. in advance of the March 28, 2011 announcement that eBay Inc. had agreed to acquire GSI. In the months prior to the announcement, Patricia received information about the acquisition of GSI from her friend, who was married to a GSI employee at the time. Patricia then tipped her father, Donald C. Zajick, and her husband, Daniel P. Melzter. Daniel, in turn, tipped his good friend, Salamone, about the upcoming acquisition of GSI. Patricia's father, Daniel, and Salamone subsequently traded on the basis of the information they received, garnering trading profits of $161,111. Patricia also tipped her good friend Lawrence M. Gincel about the upcoming acquisition of GSI. Gincel traded on the basis of the information and garnered trading profits of $1,083.

Status: On March 1, 2016, all of the parties agreed to cease and desist from future violations. In addition, Salamone agreed to pay disgorgement of $9,491, prejudgment interest of $461 and a civil penalty of $4,745. Patricia Zajick Meltzer and Daniel Meltzer agreed to pay, jointly and severally, disgorgement of $53,037, prejudgment interest of $7,791 and a civil penalty of $107,224. Donald Zajick agreed to pay disgorgement of $97,500, prejudgment interest of $4,322 and a civil penalty in the amount of $97,500. Gincel agreed to pay disgorgement of $1,083, prejudgment interest of $159 and a civil money penalty of $1,083.

SEC v. Fung; United States v. Fung; SEC v. Dowd; United States v. Dowd
Date: March 9, 2016
Agency: SEC and DOJ
Authority: Joint Civil/Criminal
Forum: D.N.J.
Event: Parallel Civil and Criminal Proceedings Initiated; Civil Settlements Reached and Guilty Pleas Entered

Summary: The SEC alleged that Fung had purchased stock and call options in Pharmasset Inc. based on his friend's tip that it was about to be acquired. The friend, Kevin Dowd, had learned the nonpublic information during his employment at an investment advisory firm where a Pharmasset board member maintained an account and confidentially sought financial advice in advance of the acquisition. Fung cashed in when Pharamasset's stock rose 84 percent after its acquisition by Gilead Sciences was publicly announced, and he paid kickbacks ($35,000) to Dowd. The DOJ brought parallel criminal actions against both Fung and Dowd.

Status: On Sept. 30, 2013, Dowd pled guilty in his criminal case. On March 9, 2016, both Dowd and Fung settled with the SEC. Dowd agreed to pay back the $35,000 cash kickbacks he received from Fung and also agreed to be barred from the securities industry and penny stock offerings. Fung agreed to pay back more than $700,000 in illegal profits and $60,000 in interest earned. On March 9, 2016, Fung also entered into a plea agreement with the DOJ. Pursuant to the plea agreement, Fung pled guilty to conspiring to commit securities fraud and consented to an entry of a forfeiture money judgment in the amount of $345,245. Fung's sentencing is scheduled for April 10, 2017.

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In the Matter of Eric J. Wolff
Date: March 16, 2016
Agency: SEC
Authority: Civil
Forum: SEC Administrative Proceeding
Event: Settled Administrative Order

Summary: The proceeding involved insider trading by Wolff in advance of the June 9, 2014 public announcement that Merck & Co. Inc. would submit a tender offer to acquire the outstanding shares of Idenix Pharmaceuticals Inc. for $3.85 billion or $24.50 per share in cash. In May 2014, Wolff obtained material nonpublic information concerning the transaction from his life partner, who was a scientist at Merck. Wolff understood that this information was conveyed to him in confidence and that he should not trade on it. However, Wolff traded Idenix securities before the public announcement of the transaction and generated ill-gotten gains of $87,600.

Status: On March 16, 2016, Wolff agreed to cease and desist from any future violations. He also agreed to pay disgorgement of $87,600, prejudgment interest of $657 and a civil penalty in the amount of $87,600, for a total of $175,857.

SEC v. John E. Hardy III
Date: March 18, 2016
Agency: SEC
Authority: Civil
Forum: U.S. District Court for the Western District of Washington (W.D. Wash.)
Event: Civil Complaint Filed; Settlement Reached

Summary: The SEC alleged that Hardy, who worked in Microsoft's corporate financial planning and analysis group, purchased Microsoft put options after learning from highly confidential internal Microsoft documents, including a draft presentation to Microsoft's board of directors, that the company's fiscal-year 2013 financial results would not meet Wall Street analysts' expectations. When Microsoft issued a July 18, 2013 earnings release containing those financial results, the company's stock price decreased over 11 percent. Hardy sold the put options shortly after the announcement, realizing ill-gotten gains of approximately $9,000. The SEC also alleged that, in August 2013, Hardy purchased Nokia call options after learning in the course of his work in the financial planning and analysis group that Microsoft was planning to acquire Nokia's mobile phone business. After the public announcement of the acquisition on Sept. 2, 2013 caused the price of Nokia American Depositary Shares trading in the United States to rise more than 30 percent, Hardy sold the Nokia call options, resulting in illegal profits of approximately $175,000.

Status: On March 18, 2016, Hardy consented to an entry of judgment permanently enjoining him from future violations. Hardy also agreed to disgorge all of his ill-gotten gains of $184,132, pay a civil penalty of $184,132 and pay prejudgment interest of $11,389, for a total of $379,653. In addition, Hardy agreed to a five-year ban from serving as an officer or director of a publicly traded company.

SEC v. Afriyie et al.; United States v. Afriyie
Date: April 13, 2016
Agency: SEC and DOJ
Authority: Joint Civil/Criminal
Forum: U.S. District Court for the Southern District of New York (S.D.N.Y.)
Event: Parallel Civil and Criminal Proceedings Initiated

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Summary: The SEC alleged that a research analyst, John Afriyie, reaped more than $1.5 million in February 2016 through trades he made in his mother's brokerage account based on nonpublic information he learned at work. More specifically, the SEC alleged that Afriyie found out about an impending acquisition of a home security company, The ADT Corporation, when prospective acquirer Apollo Global Management approached the Manhattan-based investment firm where Afriyie was employed and discussed potential debt financing for a public-to-private deal. Afriyie subsequently accessed several highly confidential, deal-related documents on the firm's computer network and purchased thousands of high-risk, out-of-the-money ADT call options in his mother's account in anticipation that ADT's stock price would rise when the transaction was publicly announced. After the ADT deal was announced, Afriyie sold all of the ADT options in his mother's account to obtain his illicit profits. The SEC's civil complaint also names Afriyie's mother as a relief defendant for the purposes of recovering ill-gotten gains that Afriyie generated by trading in his mother's name. In a parallel action, the DOJ announced criminal charges against Afriyie.

Status: On July 20, 2016, in the SEC's case against Afriyie, the DOJ moved to stay pending resolution of the criminal proceedings. On July 26, 2016, the court granted the DOJ's motion to intervene and stay the civil proceedings until the criminal proceedings against Afriyie are resolved. The DOJ's criminal case against Afriyie remains ongoing.

SEC v. Nunan
Date: May 2, 2016
Agency: SEC
Authority: Civil
Forum: U.S. District Court for the Northern District of California (N.D. Cal.)
Event: Civil Complaint Filed; Settlement Reached

Summary: The SEC alleged that Nunan, a senior engineering executive at a subsidiary of a semiconductor equipment manufacturer named Screen Holdings Company, was contacted by a board member at FSI International and confidentially informed that a Japan-based semiconductor equipment company, Tokyo Electron Ltd., was negotiating to acquire FSI. The board member knew that Nunan knew the executive responsible for evaluating potential corporate acquisitions at Screen Holdings. Nunan thereafter acted as a conduit for communications between the two companies as FSI sought a competing bid. According to the SEC's complaint, Nunan misused the confidential information entrusted to him about FSI's potential merger plans and bought 105,000 FSI shares during the next six months. He also recommended the trade to his brother, who purchased 1,000 shares of FSI stock. Once Tokyo Electron and FSI publicly announced a merger agreement on Aug. 13, 2012, Nunan sold most of his FSI stock the next day and the illicit profits from his unlawful trading and tipping totaled $254,858.

Status: On May 2, 2016, Nunan agreed to be permanently enjoined from future violations and ordered to pay $254,858 in disgorgement of ill-gotten gains plus interest of $24,587 and a penalty of $254,858 for a total of $534,303.

SEC v. Walters, et al.; United States v. Davis, et al.
Date: May 19, 2016
Agency: SEC and DOJ
Authority: Joint Civil/Criminal
Forum: S.D.N.Y.
Event: Davis Pled Guilty in Criminal Action; Mickelson and Davis settled with SEC

Summary: The SEC charged William "Billy" Walters, a sports bettor, investor, and the CEO and chairman of the Walters Group, and former Dean Foods director, Thomas Davis, with insider trading. They

allegedly operated a scheme in which Davis would leak material nonpublic information regarding Dean Foods to Walters, who in turn traded on it and shared it with the professional golfer Phil Mickelson, whom the SEC named as a relief defendant. According to the SEC's complaint, Walters was owed money by then-Dean Foods Company board member Davis. Davis regularly shared inside information about Dean Foods with Walters in advance of market-moving events, using prepaid cell phones and other methods in an effort to avoid detection. Among the various efforts made to avoid detection, Walters instructed Davis to refer to Dean Foods as the "Dallas Cowboys" during conversations. Furthermore, while Walters made millions of dollars insider trading using the confidential information, he provided Davis with almost $1 million and other benefits to help Davis address his financial debts. In addition, the SEC's complaint alleged that professional golfer Phil Mickelson traded Dean Foods' securities at Walters' urging and then used his almost $1 million of trading profits to help repay his own gambling debt to Walters. As a result of this scheme and based on the illegal tips received from Davis, Walters allegedly made $40 million. In a parallel action, the DOJ announced criminal charges against Walters and Davis.

Status: Davis pled guilty in the DOJ criminal case on May 16, 2016. On May 24, 2016, Phil Mickelson neither admitted nor denied the allegations in the SEC's complaint and agreed to pay full disgorgement of his trading profits totaling $931,738.12 plus interest of $105,291.69 (a total of $1,037,029.81). On Aug. 10, 2016, in the SEC's case against Walters, the DOJ moved to stay the case pending resolution of the criminal proceedings against Walters. On Aug. 26, 2016, the court denied the government's motion to stay. On Oct. 14, 2016, Davis settled with the SEC. The court entered a consent judgment pursuant to which disgorgement and potential civil penalties will be determined at a later date. Walters' cases remain ongoing.

SEC v. McClatchey, et al.; United States v. McClatchey; United States v. Pusey
Date: May 27, 2016
Agency: DOJ and SEC
Authority: Joint Civil/Criminal
Forum: S.D.N.Y.
Event: Parallel Civil and Criminal Proceedings Filed; Guilty Pleas by Pusey and McClatchey

Summary: The SEC alleged that Steven McClatchey, an investment banker, had regular access to highly confidential nonpublic information about impending transactions being pursued for investment bank clients. McClatchey allegedly tipped insider information that he gleaned as part of his work duties to Gary Pusey, a plumber and close friend of McClatchey's who helped remodel his bathroom. Pusey then proceeded to trade on the tips on at least 10 different occasions ahead of unannounced public mergers. He generated $76,000 in allegedly illicit trading profits. In exchange for the tips, Pusey provided McClatchey with free services as well as thousands of dollars. In parallel actions, the DOJ announced criminal charges against McClatchey and Pusey.

Status: On May 31, 2016, Pusey pled guilty. He has yet to be sentenced. On July 12, 2016, McClatchey pled guilty to conspiracy and fraud charges, and on Jan. 11, 2017, McClatchey was sentenced to five months in prison and ordered to forfeit $76,000 and pay a fine of $10,000. The SEC case remains ongoing.

SEC v. Maciocio, et al.; United States v. Maciocio
Date: June 3, 2016
Agency: SEC and DOJ
Authority: Joint Civil/Criminal
Forum: S.D.N.Y.
Event: Consent Judgment against Maciocio; Guilty Plea by Hobson

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Summary: The government alleged that Michael Maciocio, who worked in various roles at an unnamed multinational pharmaceutical corporation, used confidential information about pharmaceutical firms being considered by his employer for potential acquisitions to trade in the stock of potential targets. He allegedly gained approximately $116,000. He also allegedly tipped his childhood friend, stockbroker David P. Hobson, who traded on the nonpublic information and realized at least $187,000 in profits for himself and $145,000 for his customers. In a parallel action, the DOJ announced criminal charges against Maciocio and Hobson.

Status: On June 24, 2016, the court entered a consent judgment enjoining Maciocio from violating Section 10(b) of the Exchange Act and ordering him to pay disgorgement and a civil penalty to be determined at a later date upon motion of the SEC. On Oct. 25, 2016, Hobson pled guilty. He was ordered to forfeit $385,664 and his sentencing is scheduled for March 2, 2017.

SEC v. Ma
Date: June 9, 2016
Agency: SEC
Authority: Civil
Forum: N.D. Cal.
Event: Civil Complaint Filed; Settlement Reached

Summary: The SEC alleged that Guolin Ma, an optical physicist who served as a consultant to two China-based equity firms, traded on confidential information he obtained while advising the firms in connection with their potential buyout of Silicon Valley optical semiconductor maker OmniVision Technologies. According to the SEC's complaint, one of the firms advised by Ma joined a group of Chinese investment firms in making a bid to buy OmniVision. Ma stockpiled 39,373 shares of OmniVision stock through a series of purchases in April and May 2014 while possessing nonpublic information. OmniVision's stock price rose 15 percent when the proposed acquisition was publicly announced in August 2014, allowing Ma to generate $367,387 in illegal profits.

Status: On June 9, 2016, the SEC announced that Ma had agreed to pay disgorgement of $367,387 plus interest of $21,986 and a penalty of $367,387.

SEC v. Chan; United States. v. Chan
Date: June 14, 2016
Agency: SEC and DOJ
Authority: Joint Criminal/Civil
Forum: U.S. District Court for the District of Massachusetts (D. Mass.)
Event: Parallel Civil and Criminal Proceedings Initiated

Summary: The government alleged that Schultz Chan, a director of biostatistics at Akebia Therapeutics, purchased shares of Akebia and tipped his wife and friend (who had previously lent him about $80,000) to purchase Akebia shares ahead of a positive announcement regarding Akebia's leading drug. The three collectively earned $288,000 once the positive information was publicly announced.

Status: In the DOJ's criminal case, Chan entered a not guilty plea on Sept. 20, 2016. On Oct. 3, 2016, Chan moved to the stay the proceedings in the SEC's civil case pending resolution of the DOJ's criminal proceedings against him. On Oct. 4, 2016, the court granted Chan's motion to stay. The DOJ's criminal case against Chan remains ongoing.

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SEC v. Valvani, et al.; United States v. Valvani; SEC v. Plaford
Date: June 15, 2016
Agency: SEC and DOJ
Authority: Joint Civil/Criminal
Forum: S.D.N.Y.
Event: Parallel Civil and Criminal Proceedings Initiated; Civil Settlement Reached with Johnston

Summary: The SEC alleged that Sanjay Valvani secured unlawful profits of nearly $32 million for hedge funds investing in health care securities by trading on tips he received from Gordon Johnston, who had worked at the FDA and remained in close contact with former colleagues while working for a trade association representing generic drug manufacturers and distributors. Johnston allegedly concealed his separate role as a hedge fund consultant and obtained confidential information regarding anticipated FDA drug approvals from FDA personnel, including a close friend he had mentored during his time at the agency, and passed the information on to Valvani, who then traded in advance of public announcements concerning the approvals. The SEC further alleged that Valvani in turn tipped fellow hedge fund manager Christopher Plaford, who is charged in a separate complaint with insider trading on this, as well as other material nonpublic information. According to the complaint, Plaford profitably traded on behalf of one of the funds he managed based on material nonpublic information he received from Valvani concerning an impending approval by the FDA's Office of Generic Drugs (OGD) to permit the sale of a drug called enoxaparin. Three years later, Plaford profitably traded on behalf of managed funds based on material nonpublic information that he received confidentially from a former Centers for Medicare and Medicaid Services official and paid consultant about an impending cut to Medicare reimbursement rates for certain home health services. The former official and paid consultant informed Plaford that this information concerning the impending announcement came from sources within the Centers for Medicare and Medicaid Services. Plaford allegedly made approximately $300,000 by trading based on inside information in the hedge funds he managed. In parallel actions, the DOJ announced criminal charges against Valvani, Johnston and Plaford.

Status: On June 21, 2016, Valvani was found dead in his Brooklyn home in a suspected suicide, according to police. On July 6, 2016, the DOJ dropped all charges against Valvani. On Nov. 14, 2016, the SEC entered into a settlement agreement with Johnston. Johnston agreed to pay disgorgement in the amount of $108,000 plus interest of $19,496.03 for a total of $127,496.03. Johnston also agreed to be permanently enjoined from violating Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. On Aug. 15, 2016, the court granted the DOJ's motion to intervene and stay Plaford's civil proceedings pending the outcome of the criminal case against Plaford. The DOJ's criminal proceedings against Johnston and Plaford appear to be ongoing.

SEC v. Salis, et al.; United States v. Salis, et al.
Date: June 16, 2016
Agency: SEC and DOJ
Authority: Joint Civil/Criminal
Forum: U.S. District Court for the Northern District of Indiana (N.D. Ind.)
Event: Parallel Civil and Criminal Proceedings Initiated

Summary: On June 16, 2016, the SEC alleged that Christopher Salis, a former global vice president at SAP America (a multinational software corporation), received thousands of dollars (at least $10,400 in cash) in exchange for tips in advance of SAP's impending acquisition of Concur Technologies, an American travel management company. Specifically, Salis allegedly tipped his close friend and fellow Purdue University alum, Douglas Miller, who in turn tipped his brother Edward and mutual friend Barrett Biehl. The group, which included Salis, purchased short-term call options and realized over half a million dollars of profits less than a month after the merger's announcement. Salis' startup company later

received approximately $80,000 from Douglas Miller and his family. In a parallel case brought on Oct. 19, 2016, the DOJ announced criminal charges against Salis, Douglas Miller and Edward Miller. The SEC has also linked Salas and Douglas Miller to suspicious trades in 2007 that were made in advance of a tender offer for a company called Business Objects, where Salis worked at the time. Salas and Miller were charged with this additional count of insider trading in the SEC's complaint, which alleged illicit profits of more than $42,000.

Status: On Aug. 19, 2016, in the SEC's civil proceedings, the defendants moved to dismiss the SEC's complaint for failure to state a claim. More specifically, the defendants argued that in both instances, the SEC had failed to plead with sufficient particularity that the alleged tipper, Salis, obtained material, nonpublic information as to which he owed a duty of confidentiality to his employers, SAP and Business Objects. Furthermore with respect to the trades concerning Business Objects, the defendants argued that the SEC asserted no well-pleaded factual allegations that Salis either tipped Douglas Miller any material nonpublic information concerning the merger or that Miller otherwise knew that Salis disclosed the information in violation of a duty of confidentiality to Business Objects. On Nov. 29, 2016, the DOJ moved to intervene and stay the civil proceedings pending resolution of the criminal proceedings, and on Dec.14, 2016, the court granted the DOJ's motion to intervene and stay pending judgment in the criminal case against Salis and the other defendants. In the DOJ's criminal case, Salis, Douglas Miller and Edward Miller have all pled not guilty. The DOJ's criminal case appears to be ongoing.

SEC v. Hannon
Date: June 20, 2016
Agency: SEC
Authority: Civil
Forum: D. Mass.
Event: Civil Complaint Filed; Settlement Reached

Summary: On June 20, 2016, the SEC charged James S. Hannon, a former mid-level manager of The TJX Companies Inc., the parent company of retail store chains T.J. Maxx, Marshalls and HomeGoods, with insider trading in TJX stock. According to the SEC's complaint, Hannon, who was the northeast regional vice president for T.J. Maxx from 2011 to 2014, had daily access to confidential information about the company's sales data. Hannon purchased TJX stock in advance of press releases announcing favorable sales results and other positive financial information on five occasions in 2012 and 2013. Hannon then sold the TJX stock shortly after the stock price increased following the public issuance of the press releases. TJX expressly prohibited employees from trading in TJX securities when in possession of material nonpublic information, explaining that such insider trading violated both company policy and the law. Hannon's total profit from his trading was $26,679.

Status: On June 20, 2016, Hannon consented to the entry of a final judgment that would permanently enjoin him from future violations of Section 10(b) and Rule 10b-5. He also agreed to pay disgorgement of $26,679, prejudgment interest of $3,008.99 and a civil penalty of $26,679.

SEC v. Kerr
Date: June 29, 2016
Agency: SEC
Authority: Civil
Forum: N.D. Cal.
Event: Civil Complaint Filed; Kerr's Motion to Dismiss Denied

Summary: The SEC alleged that Andrew Kerr, the younger brother of an executive at fingerprint sensor maker AuthenTec Inc. (which was ultimately purchased by Apple in 2012), bought AuthenTec shares

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based on material nonpublic information that he learned from his mother, who in turn learned it from the older brother. Specifically, the older brother divulged information regarding the company's potential acquisition by Apple to the mother, who soon after informed Kerr of the negotiations. Kerr proceeded to purchase AuthenTec stock, which included funds borrowed from his mother (for the stated purpose of financing a new home). Kerr liquidated his positions after the acquisition's public announcement, and profited $68,439.

Status: On Aug. 22, 2016, Kerr filed a motion to dismiss for failure to state a claim. In his motion, Kerr argued that the SEC failed to allege any facts demonstrating that Kerr's mother actually received material, nonpublic information regarding the acquisition from Kerr's older brother. According to Kerr, the SEC wholly failed to allege that his brother passed any material nonpublic information to his mother. Moreover, Kerr contended that the SEC had failed to allege sufficient facts to establish that Kerr's mother passed material nonpublic information to him. Therefore, in Kerr's view, the SEC had failed to state a claim for insider trading. Oral argument was scheduled for Nov. 10, 2016. On Nov. 10, 2016, the court denied Kerr's motion to dismiss and referred the case to a magistrate judge for settlement conference, to be completed within 60 days. No settlement seems to have been reached and the case appears to be ongoing.

SEC v. Avent, et al.
Date: July 7, 2016
Agency: SEC
Authority: Civil
Forum: U.S. District Court for the Northern District of Georgia (N.D. Ga.)
Event: Civil Complaint Filed; Settlement Reached with Penna

Summary: The SEC filed an insider trading suit in Georgia federal court accusing Thomas W. Avent, Jr., an Atlanta mergers and acquisitions attorney and certified public accountant, and two individuals with connections to the securities industry, Raymond J. Pirrello, Jr., and Lawrence J. Penna, of insider trading in the securities of Radiant Systems Inc., Midas Incorporated Inc. and Brightpoint Inc. According to the SEC's complaint, Avent, while working as a partner in charge of KPMG LLP's accounting and consulting mergers and acquisitions tax practice for the southeast region, obtained highly confidential information about the impending acquisitions of Radiant, Midas and Brightpoint in advance of each acquisition. Avent allegedly tipped his stock broker Pirello about the impending acquisitions, who in turn, used the nonpublic information to tip a former colleague and long-time friend Penna, who traded in the securities of each of the three companies. Avent and Pirello's tips resulted in Penna and his family realizing at least $111,000 in illicit trading profits. In exchange for the tips, Penna allegedly made payments to Pirello, and Pirrello provided cash and other financial benefits to Avent.

Status: On Oct. 25, 2016, Penna settled with the SEC. The court entered a final judgment ordering Penna to pay disgorgement and a civil penalty of $79,992 each. On Sept. 13, 2016, Avent moved to dismiss the SEC's complaint against him for failure to state a claim. According to Avent's motion to dismiss, the SEC failed to plausibly allege that he breached any fiduciary duty owed to his employer. Avent's motion to dismiss also argues that the SEC has failed to allege that Avent acted with scienter or that he received a personal benefit in exchange for the tips. Avent's motion to dismiss remains pending. The case against Avent and Pirrello is ongoing.

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In the Matter of Yi Chen, CPA
Date: July 26, 2016
Agency: SEC
Authority: Civil
Forum: SEC Administrative Proceeding
Event: Settled Administrative Order

Summary: These proceedings involved insider trading by Chen, a certified public accountant and the former corporate controller of Oplink Communications Inc. The SEC alleged that in October 2014, Chen learned, in the course of her employment, material nonpublic information regarding a planned acquisition of Oplink by Koch Industries Inc. Soon thereafter, Chen purchased a total of 4,740 shares of Oplink stock at prices ranging from $16.57 to $16.98 per share in two brokerage accounts held in the names of her relatives. On Nov. 9, 2014, Oplink and Koch announced the acquisition to the market and Oplink's stock price increased nearly 14 percent to $24.18 per share. In the weeks after, Chen sold all of the Oplink stock in her family members' accounts, realizing ill-gotten gains of $34,678.44.

Status: Chen agreed to cease and desist from future violations. Chen was also prohibited from acting as an officer or director for any issuer for a period of five years. In addition, Chen agreed to pay disgorgement of $34,678.44, prejudgment interest of $1,407.87 and a civil penalty of $34,678.44 for a total of $70,764.75.

SEC v. Kosinski; United States v. Kosinski
Date: Aug. 3, 2016
Agency: DOJ and SEC
Authority: Joint Civil/Criminal
Forum: D. Conn.
Event: Parallel Civil and Criminal Proceedings Initiated

Summary: The government alleged that Dr. Edward Kosinski traded in advance of two negative news announcements by Regado Biosciences Inc., which was pursuing a drug called REG-1 to regulate clotting in patients undergoing coronary angioplasty. Kosinski, who was president of Connecticut Clinical Research and served as a principal investigator at a clinical site involved in the drug trial, sold 40,000 Regado shares after he received advance notice from the manager of the trial that patient enrollment in the trial would be suspended because patients had experienced severe allergic reactions. Consequently, Kosinski avoided approximately $160,000 in losses when the news became public and the stock price dropped. Later, Kosinski received additional material nonpublic information from the trial manager informing him that the clinical trial would be permanently halted because a patient had died. He purchased stock options and bet that the price would drop again. Kosinski made more than $3,000 when he exercised the options after the company's stock fell by 60 percent in the wake of the negative news. A parallel criminal case was brought by the DOJ.

Status: On Nov. 22, 2016, in the SEC's civil proceeding against Kosinski, Kosinski put forth an unopposed motion to stay pending resolution of the criminal proceedings. On Nov. 29, 2016, the court denied the motion to stay. However, pursuant to a scheduling order issued the same day, the court ordered that discovery would commence at the conclusion of the corresponding criminal trial. Kosinski's criminal case appears to be ongoing.

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United States v. Klein, et al.
Date: Aug. 4, 2016
Agency: DOJ
Authority: Criminal
Forum: U.S. District Court for the Eastern District of New York (E.D.N.Y.)
Event: Indictment Filed

Summary: On Aug. 4, 2016, a grand jury in the Eastern District of New York returned a two-count indictment against Klein and Schulman. The indictment charged Tibor Klein and Robert Schulman with conspiracy to commit securities fraud and securities fraud based on facts that formed the basis of an SEC action against the two just two years earlier. According to the allegations, patent attorney Robert Schulman informed his investment adviser, Tibor Klein, that Schulman's client, King Pharmaceuticals, was going to be acquired by Pfizer Inc. Schulman allegedly passed the information to Klein while the two were having dinner, together with Schulman's wife, at Schulman's home. Klein then passed the information to Michael Shechtman. Klein and Shechtman subsequently purchased and traded King securities in advance of the acquisition's public announcement. Klein allegedly earned $8,824 in illicit profits for himself and $319,550 in illicit profits for his clients. Shechtman allegedly earned approximately $109,000 in illicit profits.

Status: The case remains ongoing.

SEC v. Rampoldi, et al.; United States v. Rampoldi, et al.
Date: Aug. 11, 2016
Agency: SEC and DOJ
Authority: Joint Civil/Criminal
Forum: U.S. District Court for the Southern District of California (S.D. Cal.)
Event: Parallel Civil and Criminal Proceedings Initiated

Summary: The SEC alleged that Paul Rampoldi, a stockbroker, and his friend William Scott Blythe, purchased shares of Ardea Biosciences based on tips received from a then-IT executive at Ardea Biosciences. The Ardea employee tipped one of Rampoldi's colleagues at the firm ahead of the company's announcement of an agreement to license a cancer drug and ahead of its acquisition by AstraZeneca PLC. The colleague, in turn, informed Rampoldi of the nonpublic information. To avoid detection at his brokerage firm, Rampoldi tipped the information to Blythe, who then purchased call options in his own brokerage account. They subsequently split the profits, which amounted to approximately $90,000. In a parallel action, the DOJ brought criminal charges against Rampoldi and Blythe.

Status: On Aug. 17, 2016, the DOJ moved to intervene and stay the civil proceedings pending resolution of the criminal case. On Oct. 27, 2016, the court denied the DOJ's motion to intervene and stay the civil proceedings. On Dec. 20, 2016, Rampoldi moved to stay the SEC's civil proceedings pending resolution of the parallel criminal against him and Blythe. The criminal case against Rampoldi and Blythe appears to be ongoing.

SEC v. Leon G. Cooperman and Omega Advisors, Inc.
Date: Sept. 21, 2016
Agency: SEC
Authority: Civil
Forum: U.S. District Court for the Eastern District of Pennsylvania (E.D. Pa.)
Event: Civil Complaint Filed

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Summary: The SEC alleged that Leon G. Cooperman, the hedge fund manager who founded Omega Advisors, Inc., used material nonpublic information that he learned from a senior executive of Atlas Pipeline Partners LP (an oil pipeline company in which Cooperman also holds a substantial equity stake) to purchase Atlas securities ahead of the sale of Atlas's natural gas processing facility in Elk City, Oklahoma. Cooperman allegedly used his status as one of Atlas Pipeline's largest shareholders to gain access to the executive and obtain confidential details about the sale of this substantial company asset. Cooperman and Omega Advisors allegedly accumulated Atlas Pipeline securities despite explicitly agreeing not to use the material nonpublic information for trading purposes, and when Atlas Pipeline publicly announced the asset sale, its stock price jumped more than 31 percent. At Cooperman's direction, the Cooperman Offshore Account, Hedge Fund Accounts, Managed Accounts and Family Accounts allegedly made significant ill-gotten gains by trading on the basis of this material nonpublic information about Atlas Pipeline's Elk City sale, generating profits of approximately $4.09 million. The SEC seeks disgorgement of ill-gotten gains plus interest, penalties and permanent injunctions against Cooperman and Omega Advisors as well as an officer-and-director bar against Cooperman.

Status: On Dec. 9, 2016, Cooperman and Omega Advisors Inc. filed a motion to dismiss for failure to state a claim. The defendants' motion argues that the SEC's complaint fails to state a claim for insider trading under the misappropriation theory because it fails to allege with particularity that an agreement not to trade (which establishes a relationship of trust and confidence) in fact arose before material nonpublic information was supposedly shared. Consequently, according to the motion, because the SEC failed to allege that an agreement to keep information confidential (or not to trade) was made before the Atlas Pipeline executive shared the material nonpublic information with Cooperman, the SEC's complaint fails to state a claim for insider trading. In this view, without an agreement to keep information confidential, Cooperman never misappropriated material nonpublic information from the Atlas Pipeline executive when he subsequently traded on the information. The SEC responded to Cooperman and Omega's motion to dismiss on Jan. 6, 2017.

SEC v. Colin Whelehan and Sheren Tsai
Date: Sept. 22, 2016
Agency: SEC
Authority: Civil
Forum: S.D.N.Y.
Event: Consent Judgments Against Defendants

Summary: The SEC alleged that Tsai, who then worked at an investment advisory firm, traded in shares of ADT Corp. on the basis of material nonpublic information that she received from her romantic partner, Whelehan. According to the complaint, Whelehan, who was a senior associate at a different investment advisory firm at the time, provided Tsai with inside information that he obtained in the course of his employment regarding an impending acquisition of ADT by funds managed by affiliates of Apollo Global Management, LLC. After receiving the nonpublic information from Whelehan, Tsai purchased 1,500 shares of ADT stock. On that same day, Tsai also recommended to a close relative to purchase ADT stock. Later that day, Tsai's close relative purchased 343 shares of ADT stock. Whelehan did not trade in ADT stock. According to the complaint, when ADT's acquisition was announced on Feb. 16, 2016, its stock price rose 48 percent, resulting in Tsai and her close relative generating illicit profits of approximately $19,500 and $4,414, respectively.

Status: On Sept. 23, 2016, the court entered final consent judgments against both defendants. Whelehan was ordered to pay $23,914 in civil penalties and was enjoined from future violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. Tsai was ordered to pay disgorgement and a civil penalty of $23,914 each. She was also enjoined from future violations.

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In the Matter of Syed Hashim
Date: Sept. 26, 2016
Agency: SEC
Authority: Civil
Forum: SEC Administrative Proceeding
Event: Settled Administrative Order

Summary: The SEC's order found that Vijay S. Rajan learned about an impending acquisition of the outstanding shares of Synageva BioPharm Corp. by Alexion Pharmaceuticals Inc. through his work as an information technology executive at Alexion. Ahead of the announcement of Alexion's acquisition of the outstanding shares of Synageva by Alexion, Rajan traded both Alexion and Synageva stock based on material nonpublic information concerning the transaction, reaping $10,032.10 in illicit profits. Rajan also tipped his friend and former colleague, Hashim. Hashim purchased Synageva stock prior to the announcement and earned over $35,747.91 in profits.

Status: Hashim agreed to pay disgorgement of $35,747.91, prejudgment interest of $1,147.86 and a civil penalty in the amount of $35,747.91.

SEC v. Coppero del Valle, et al.
Date: Sept. 28, 2016
Agency: SEC
Authority: Civil
Forum: S.D.N.Y.
Event: Civil Complaint Filed; Judgment against Coppero del Valle

Summary: The SEC alleged that Nino Coppero del Valle, a Peruvian lawyer who worked at HudBay Minerals Inc. (a Canadian mining company) as part of a business team responsible for HudBay's Peruvian mine operations, tipped two friends about HudBay's upcoming tender offer to acquire Augusta Resource Corporation, a NYSE-listed copper mining business. Specifically, Coppero passed the information to Julio Antonio Castro Roca, a close friend and a fellow attorney. Coppero and Castro allegedly traded on the material nonpublic information through a brokerage account held by a British Virgin Islands shell company in an attempt to avoid having the trades traced back to them. According to the SEC's complaint, they earned over $112,000 after the tender offer was announced. Coppero also passed the information to Ricardo Carrion, a business acquaintance who worked at a Peruvian brokerage firm, when seeking his advice about making illegal trades untraceable. Carrion caused the brokerage firm to purchase Augusta shares ahead of the tender offer's public announcement. Carrion's brokerage firm obtained $73,000 in alleged profits. The SEC's complaint seeks disgorgement of ill-gotten gains plus interest and penalties among other things.

Status: On Nov. 30, 2016, the court entered a consent judgment against Coppero del Valle, permanently enjoining him from future securities violations. Coppero del Valle may be liable to pay disgorgement of ill-gotten gains, prejudgment interest and a civil penalty upon a motion by the SEC and a decision as to the appropriate amounts by the court.

SEC v. Gadimian; United States v. Gadimian
Date: Sept. 29, 2016
Agency: SEC and DOJ
Authority: Joint Civil/Criminal
Forum: D. Mass.
Event: Parallel Civil and Criminal Proceedings Initiated

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Summary: The SEC charged the former senior director of regulatory affairs for Puma Biotechnology with insider trading ahead of the company's new announcements about its drug to treat breast cancer. More specifically, the SEC alleged that Robert Gadimian traded on material nonpublic information relating to two clinical trials for Puma's drug. Gadimian allegedly bought shares and short-term call options after learning about positive developments for the drug and profited more than $1.1 million after the results became public. The DOJ announced parallel criminal charges against Gadimian.

Status: On Dec. 5, 2016, the SEC's case against Gadimian was stayed pending resolution of the DOJ's criminal case against Gadimian. The DOJ's criminal case against Gadimian remains ongoing.

SEC v. Cope; United States v. Cope
Date: Oct. 21, 2016
Agency: SEC and DOJ
Authority: Joint Civil/Criminal
Forum: U.S. District Court for the Middle District of Tennessee (M.D. Tenn.)
Event: Parallel Civil and Criminal Proceedings Initiated; Plea Agreement Entered into by Cope

Summary: The SEC charged James C. Cope, a Tennessee-based lawyer who served on the executive committee of the board of directors of Pinnacle Financial Partners (a Nashville-based bank holding company), with insider trading based on nonpublic information he learned about an impending merger. The SEC alleged that Cope obtained more than $56,000 in ill-gotten gains by purchasing securities in Pinnacle's unannounced acquisition target, Avenue Financial Holdings (also a bank holding company), prior to the banks' joint public announcement later that month. According to the SEC's complaint, Cope learned confidential details about the planned merger during a board executive committee meeting in January 2016, and proceeded to place his first order to purchase Avenue Financial stock while that executive committee meeting was still in progress. Cope allegedly placed four more orders in Avenue Financial within an hour after the meeting had ended. The DOJ filed a parallel criminal case against Cope.

Status: On Dec. 13, 2016, Cope entered into a plea agreement with the DOJ. Cope pled guilty to insider trading and was sentenced to two years of probation and nine months of supervised home detention. Cope was also ordered to pay a $100 assessment and a fine of $200,000. The SEC's case against Cope appears to be ongoing.

SEC v. Ly; United States v. Ly
Date: Dec. 5, 2016
Agency: SEC and DOJ
Authority: Joint Civil/Criminal
Forum: W.D. Wash.
Event: Parallel Civil and Criminal Proceedings Initiated; Civil Settlement Reached

Summary: The SEC alleged that Ly, who worked in Expedia's corporate IT services department, illegally traded in advance of nine company news announcements from 2013 to 2016 and generated nearly $350,000 in profits. According to the SEC's complaint, Ly exploited administrative access privileges designated for IT personnel to remotely hack into computers and email accounts of senior executives and review confidential documents and pre-earnings reports. Ly particularly targeted information prepared by Expedia's head of investor relations summarizing Expedia's yet-to-be-announced earnings and describing how the market could react to particular announcements. Ly allegedly used this nonpublic information to make highly profitable trades in Expedia securities ahead of the announcements. In a parallel action, the DOJ announced criminal charges against Ly.

Status: To settle the charges in the SEC's complaint, Ly agreed to pay disgorgement of $348,515.72 plus interest of $27,391.30, for a total of $375,907.02. The DOJ's criminal proceeding against Ly appears to be ongoing.

In the Matter of Jo Ann Myers and Hollis Pickett
Date: Dec. 16, 2016
Agency: SEC
Authority: Civil
Forum: SEC Administrative Proceeding
Event: Settled Administrative Order

Summary: The SEC alleged that Myers, the wife of an officer of Alimera Sciences Inc., a Georgia-based biopharmaceutical company, became aware of material nonpublic information that she misappropriated from her husband and subsequently used the information to tip her son, father and stepmother, leading her son and father to sell a total of 24,440 shares of Alimera stock ahead of a negative news announcement that the U.S. Food and Drug Administration would not approve Alimera's new drug application for Illuvien, a drug used to treat diabetes. Myers' actions allegedly resulted in her son and father avoiding combined losses of $31,661.20. The SEC further alleged that Myers tipped the same relatives ahead of a positive news announcement that Alimera and the FDA had made significant progress in addressing issues related to the FDA's approval of Illuvien. As a result of the tip, Myers' son and father purchased a total of 5,444 shares of Alimera stock, generating combined profits of $8,744.49. Ahead of this same positive news announcement and aware of material nonpublic information misappropriated from Myers' husband, Pickett also allegedly purchased and directed his son to purchase Alimera stock, resulting in profits totaling $8,656.50.

Status: On Dec. 16, 2016 Myers agreed to pay disgorgement of $40,405.69, prejudgment interest of $2,762.36 and a civil penalty of $40,405.69. Pickett agreed to disgorge $8,656.50, pay prejudgment interest of $555.07 and pay a penalty of $8,656.50.

SEC v. Hong et al.; United States v. Hong et al.
Date: Dec. 27, 2016
Agency: SEC and DOJ
Authority: Joint Civil/Criminal
Forum: S.D.N.Y.
Event: Parallel Civil and Criminal Proceedings Initiated

Summary: The SEC alleged that Iat Hong, Bo Zheng and Hung Chin executed a scheme to hack into the networks of two prominent New York-based law firms and steal confidential information pertaining to firm clients that were considering mergers or acquisitions. The alleged hacking incidents involved installing malware on the law firms' networks, compromising accounts that enabled access to all email accounts at the firms, and copying and transmitting dozens of gigabytes of emails to remote internet locations. Once Hong, Zheng and Chin obtained accessed to the law firms' networks, they targeted email accounts of law firm partners who worked on high-profile mergers and acquisitions transactions. According to the SEC's complaint, Hong, Zheng and Chin subsequently used the stolen confidential information contained in the emails to purchase shares in at least three public companies ahead of public announcements about entering into merger agreements. Hong, Zheng and Chin then sold the shares they purchased after the acquisitions were publicly announced, garnering over $4 million in profits. In each case, one of the two law firms represented either the target or a contemplated or actual acquirer in the transaction. In a parallel action, the DOJ brought criminal charges against Hong, Zheng and Chin.

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Status: Both cases remain ongoing.

B. Important Rulings/Resolutions

1. Cases Discussing *Newman* and the Personal Benefit Standard

United States v. Riley
Date: Jan. 14, 2016
Agency: DOJ
Authority: Criminal
Forum: U.S. Court of Appeals for the Second Circuit (2d Cir.)
Event: Riley's Challenge to Conviction Rejected

Summary: The government alleged that former vice president of Foundry Networks Inc., David Riley, gave nonpublic information about his company to investment advisory analyst, Matthew Teeple, who advised a group of hedge funds that made more than $16 million in profits and avoided more than $11 million in losses. Teeple also gave the information to pension investment officer, John Johnson, who earned over $136,000 in illicit profits.

Status: On Oct. 2, 2014, a jury found Riley guilty of one count of conspiracy and two counts of securities fraud. The jury deadlocked on a third count of securities fraud. On March 3, 2015, the court denied Riley's motion for a new trial based on the decision in *Newman*. The court ruled that the government had proven that Riley obtained "concrete" benefits in exchange for his tips. Those benefits included investment advice, help with a side business and assistance in securing a new job. Riley was sentenced to 78 months in prison on April 27, 2015. On Jan. 14, 2016, the Second Circuit rejected an appeal by Riley in which Riley challenged the sufficiency of the evidence supporting his conviction (particularly in the wake of *Newman*), several evidentiary rulings, the jury instructions and the calculation of his Guidelines range. *See United States v. Riley*, 638 Fed. Appx. 56 (2d Circuit 2016). The court noted that Riley, the tipper, did in fact receive an immediate pecuniary and tangible benefit in the form of investment advice and profitable purchases of stock. These benefits satisfied the personal benefit standard set forth in *Newman*. *Id.* at 61.

United States v. Smith
Date: March 25, 2016
Agency: DOJ
Authority: Criminal
Forum: S.D.N.Y.
Event: Smith's Petition to Correct Original Judgment Denied

Summary: The government alleged that Smith, while working as a portfolio manager or analyst at the Galleon Group, obtained material nonpublic information from various insiders at publicly traded companies and financial services firms. The government alleged that Smith also shared this information with others at Galleon and used the information to trade securities in accounts affiliated with Galleon.

Status: On Jan. 26, 2011, Smith pled guilty to one count of conspiracy to commit securities fraud and one count of securities fraud. On Dec. 7, 2015, Smith filed a petition for a writ of error coram nobis. Smith argued that he could not have violated insider trading law as characterized in *United States v. Newman* given the lack of evidence in his case of a quid pro quo or any consequential benefit received by a tipper in exchange for insider information. The court, however, denied Smith's request, finding that the tips Smith received involved a personal benefit which met the *Newman*

standard. *See United States v. Smith*, 11 Cr. 0079 (JSR), 2016 WL 1248961, at *3 (S.D.N.Y. Mar. 25, 2016). Because one of the insiders in Smith's case would receive a consulting fee (with the money directed to a third party controlled by the insider) in exchange for the insider information, the court found that Smith's arrangement easily met the *Newman* standard of an objective, consequential exchange providing a gain of pecuniary or similarly valuable nature. *Id.*

Barnetson v. United States
Date: May 6, 2016
Agency: DOJ
Authority: Criminal
Forum: S.D.N.Y.
Event: Barnetson's Petition to Correct Original Judgment Denied

Summary: Barnetson was charged with conspiracy to commit wire fraud and securities fraud. On Feb. 17, 2012, Barnetson pled guilty and on June 25, 2013, he was sentenced to a one-year term of probation.

Status: On Dec. 18, 2015, Barnetson petitioned the court for a writ of coram nobis, arguing that the factual basis for his guilty plea was insufficient under *United States v. Newman*. In particular, Barnetson argued that his guilty plea did not meet *Newman's* personal benefit requirement because he did not specifically allocute to receiving a personal benefit. He also argued that the confidential information he received was of no personal benefit to him, and the other gifts were de minimis. The court denied Barnetson's request, finding that the expensive meals, shipments of food and confidential information about other technology companies and industry trends that Barnetson received did in fact satisfy the standard set forth in *Newman*. According to the court, expensive meals and shipments of food are benefits of a pecuniary or similarly valuable nature.

SEC v. Spivak, et al.
Date: July 12, 2016
Agency: SEC
Authority: Civil
Forum: D. Mass.
Event: Spivak's Motion to Dismiss Denied

Summary: The SEC alleged that Vlad Spivak traded on tips in advance of an unannounced acquisition of a dental practice management company. He allegedly received the tips from former Wells Fargo Bank NA financial analyst Shirmila Doddi, with whom he was in a romantic relationship. After the transaction was announced, Spivak realized profits of over $220,000.

Status: On Jan. 20, 2016, the court entered a consent judgment as to Doddi. She was enjoined from violating Section 10(b) of the Exchange Act, with disgorgement and a civil penalty to be determined at a later date. Spivak moved to dismiss the SEC's complaint, contending that the complaint failed to allege that Doddi received an objective, pecuniary personal benefit from tipping him. On July 12, 2016, the court denied Spivak's motion to dismiss, finding that the complaint sufficiently pled that Doddi received a personal benefit by tipping Spivak and thus breached her fiduciary duty to her employer. The court found that Spivak's relationship with Doddi was close enough (given its romantic nature) to satisfy the standards for insider trading under both First Circuit precedent and the Second Circuit's *Newman* decision. *See SEC v. Spivak*, No. 15-13704-FDS, 2016 WL 3774196, at *6-12 (D. Mass. July 12, 2016).

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United States v. McPhail
Date: July 26, 2016
Agency: DOJ
Authority: Criminal
Forum: U.S. Court of Appeals for the First Circuit (1st Cir.)
Event: McPhail's Motion to Dismiss Denied; McPhail's Conviction Upheld

Summary: The government alleged that from July 2009 through April 2011, Eric McPhail misappropriated confidential information regarding American Superconductor Corporation that he learned from a close friend and golfing buddy who was an executive with the company by providing it to his friends, Douglas A. Parigian, John J. Gilmartin, Douglas Clapp, James A. Drohen, John C. Drohen and Jamie A. Meadows, who then made a total of more than $554,000 of illegal profits by trading on the information regarding expected earnings, contracts, and other corporate developments. The DOJ brought criminal charges against McPhail for his role in the illegal trading.

Status: In March 2015, McPhail moved to dismiss the criminal indictment against him, and the court denied the motion on May 12, 2015. On June 16, 2015, a jury convicted McPhail of securities fraud and conspiracy to commit securities fraud. On Sept. 17, 2015, he was sentenced to 18 months in prison. He appealed his conviction to the First Circuit. On July 26, 2016, the First Circuit affirmed his conviction, holding that evidence McPhail expected to receive dinners, wine, a spa visit, $3,000 and general gratitude from his tippees was sufficient to show that McPhail anticipated receiving a personal benefit in return for the tips. *United States v. McPhail*, 831 F.3d 1, 11 (1st Cir. 2016).

SEC v. Andrade
Date: Nov. 1, 2016
Agency: SEC
Authority: Civil
Forum: U.S. District Court for the District of Rhode Island (D. R.I.)
Event: Defendants' Motion to Dismiss Denied; Judgments Entered Against Defendants

Summary: The SEC alleged that printing business owner Anthony Andrade tipped three of his friends and business associates — real estate investor Robert Kielbasa, printing business co-owner Fred Goldwyn, and attorney Kenneth Rampino — prior to the announcement of the acquisition of Bancorp of Rhode Island Inc., for which Andrade was a director, at a premium to its stock price, and that the three friends then traded on the information and made more than $80,000 in illicit profits.

Status: In June 2015, prior to the announcement of the SEC's complaint, Kielbasa and Goldwyn entered into consent agreements whereby Kielbasa agreed to a civil penalty and disgorgement of $39,645 each and Goldwyn agreed to a civil penalty and disgorgement of $23,565 each. Once the complaint was filed, Andrade and Rampino moved to dismiss, alleging that the SEC had failed to allege facts showing the requisite relationship and benefit to the tipper described by the Second Circuit in *Newman*. However, on Jan. 15, 2016, the court denied their motions, holding that the SEC had sufficiently pled personal benefit to the tipper. *See SEC v. Andrade*, 157 F. Supp. 3d 124 (D. R.I. 2016). The court noted that even if the SEC had to prove a potential gain of a pecuniary or similarly valuable nature, the SEC's complaint stated a plausible claim given the SEC's allegation that Andrade had personally went with one of his property service vendors to Rampino's home to help resolve a septic issue for Rampino. *Id.* at 129. According to the court, such an allegation made it highly plausible that Rampino and Andrade had the type of relationship where there was a give and take that had the potential for pecuniary gain. *Id.* On Nov. 1, 2016, the federal district court in Rhode Island entered a final judgment against Andrade, ordering him to pay $150,000. Andrade consented to the judgment which also permanently enjoined him from future violations of Section 10(b) of the

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Securities Exchange Act of 1934 and Rule 10b-5 thereunder. The judgment also ordered Rampino to pay a civil penalty of $150,000 and barred Rampino from serving as an officer or director of a public company.

SEC v. Payton
Date: Nov. 28, 2016
Agency: SEC
Authority: Civil
Forum: S.D.N.Y.
Event: Defendants' Motions for Judgment as a Matter of Law or a New Trial Dismissed

Summary: The SEC brought an action against Payton and Durant, alleging that they were remote tippees who traded on inside information of a planned corporate acquisition. More specifically, the SEC alleged that Dallas, a lawyer working for IBM's outside counsel, learned in the course of his work that IBM planned to acquire SPSS Inc. ("SPSS"). Dallas subsequently told his friend, Martin, about the SPSS acquisition. Martin tipped his friend and roommate Conradt, and Conradt in turn tipped two of his coworkers, Payton and Durant, who traded on the information.

Status: After Payton and Durant were found civilly liable, they filed a motion for judgment as a matter of law or a new trial, and sought reconsideration of the amount and payment terms of their respective civil penalties. In addition to a host of other arguments, the defendants contended that there was insufficient evidence to find that they knew or had reason to know that Martin disclosed the SPSS information in exchange for a personal benefit. Noting that Payton and Durant neither asked Conradt how his roommate came by the information nor why his roommate shared it with them, the court determined that Payton and Durant's actions were classic examples of conscious disregard. *See SEC v. Payton*, 14 Civ. 4644, 2016 WL 6948685, at *5 (S.D.N.Y. Nov. 28, 2016). According to the court, the defendants' conduct after the SPSS acquisition was announced supported an inference that they generally understood, but had consciously avoided learning, the means by which the confidential SPSS information had been obtained. *Id.* In short, the court found that there was plentiful evidence from which the jury could have concluded that defendants deliberately chose not to ask Conradt questions about the circumstances in which Martin told him about the confidential SPSS information, because they understood that there was a high probability that they would have learned of Martin's personal benefit. *Id.* According to the court, insider trading law could not be circumvented so easily. Finding both this argument and the defendants' remaining arguments lacking, the court dismissed the defendants' motion for judgment as a matter of law or a new trial. *Id.*

Salman v. United States
Date: Dec. 6, 2016
Agency: DOJ
Authority: Criminal
Forum: Supreme Court of the United States
Event: Salman's Conviction Upheld

Summary: The government alleged that Citigroup investment banker Maher Kara passed inside information regarding Biosite Inc.'s impending acquisition by Beckman Coulter Inc. to his brother, Mounir ("Michael") Kara, who provided it to defendant Bassam Yacoub Salman (the Karas' brother-in-law), who in turn passed it to his brother-in-law, Karim Bayyouk, who traded on it and shared some of the profits with Salman. Michael Kara also allegedly tipped Emile Jilwan, Joseph Azar and Zahi Haddad. Azar and Haddad were not prosecuted criminally.

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Status: On Sept. 30, 2013, Salman was convicted after a jury trial. On April 9, 2014, he was sentenced to 36 months imprisonment and ordered to pay $738,539.42 in restitution. Salman appealed, and the Ninth Circuit affirmed on July 6, 2015. On Jan. 19, 2016, the U.S. Supreme Court agreed to hear Salman's appeal. On Dec. 6, 2016 the Supreme Court unanimously upheld Salman's conviction. The Court reaffirmed the personal benefit test articulated in *Dirks v. SEC*, 463 U.S. 646 (1983), and held that the Ninth Circuit had properly applied *Dirks* in concluding that a tipper benefits personally by making a gift of confidential information to a trading relative or friend. The Court went on to explain that "to the extent the Second Circuit [in *Newman*] held that the tipper must also receive something of a pecuniary or similarly valuable nature in exchange for a gift to family or friends," "this requirement is inconsistent with *Dirks*." Importantly, however, the Supreme Court's decision in Salman does not cast doubt on the Second Circuit's reversal of the two hedge fund traders' convictions in *Newman*. That is, the Supreme Court's decision refrained from answering what personal benefit is required for tipper-tippee liability outside the factual scenario presented by *Salman*. In *Salman*, the Supreme Court did not address the government's argument that a gift of confidential information to anyone, not just a family member or friend, should be sufficient to prove insider trading. Accordingly, a gift made to a complete stranger, a mere acquaintance or a colleague may require a finding of something of value to satisfy the personal benefit element. Further, arguably the most consequential holding of *Newman* — that a remote tippee must know that the tipper received a personal benefit in exchange for the tip — remains unchanged. The Court made it clear that *Salman* does not implicate that holding of *Newman*.

2. Failure to Supervise Cases

SEC v. Steven A. Cohen
Date: Jan. 8, 2016
Agency: SEC
Authority: Civil
Forum: SEC Administrative Proceeding
Event: Settled Administrative Order

Summary: The SEC brought failure to supervise charges against SAC Capital Advisors LLC founder Steven A. Cohen for his alleged failure to prevent SAC employees Mathew Martoma and Michael Steinberg from engaging in insider trading that allegedly produced profits and avoided losses totaling $275 million in SAC-advised hedge funds. The SEC's order found that Cohen failed to supervise former portfolio manager Mathew Martoma and that Cohen ignored red flags that should have caused him to take prompt action to determine whether Martoma was engaging in insider trading. Instead, Cohen permitted Martoma to make trades based on material nonpublic information and Cohen placed similar trades in accounts that Cohen controlled.

Status: On Jan. 8, 2016, the SEC and Cohen reached a settlement prohibiting Cohen from supervising funds that manage outside money until 2018. Cohen is barred from serving in a supervisory role at any broker, dealer or investment adviser until Dec. 31, 2017 (until 2018). Under the terms of the settlement Cohen's family office firms are also required to retain an independent consultant and adopt all of the independent consultant's recommendations.

In re Vincent Sbarra
Date: Jan. 20, 2016
Agency: FINRA
Authority: Civil
Forum: FINRA Proceeding
Event: Settlement Reached

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Summary: FINRA alleged that Sbarra, the president, CCO and designated supervisory principal of StreetCapital (a FINRA registered broker-dealer), failed to establish and maintain reasonable Written Supervisory Procedures ("WSPs") to enable the firm to monitor for and detect insider trading. Sbarra allegedly failed to include in the firm's WSPs any guidance as to the circumstances under which the securities of an issuer with whom the firm had entered into an investment banking agreement would be placed on a Restricted List. Subsequently, a certain issuer was not timely placed on the firm's Restricted List and a member of the firm traded in the securities of that particular issuer.

Status: On Jan. 20, 2016, FINRA announced a settlement with Sbarra pursuant to a Letter of Acceptance, Waiver and Consent in which FINRA found that Sbarra had violated NASD Rule 3010(b) and FINRA Rule 2010 by failing to establish and maintain reasonable WSPs to monitor for and detect insider trading. Accordingly, Sbarra agreed to a fine of $10,000 and a 90-day suspension from association with any FINRA regulated broker-dealer in a principal capacity.

In the Matter of Artis Capital Management, L.P. and Harden
Date: Oct. 13, 2016
Agency: SEC
Authority: Civil
Forum: SEC Administrative Proceeding
Event: Settled Administrative Order

Summary: The SEC's order found that Artis Capital Management failed to supervise Matthew Teeple, an Artis employee who procured material nonpublic information from an insider at a public company. Artis also failed to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of material nonpublic information consistent with the nature of its business. More specifically, on at least two occasions in 2008, Teeple obtained material nonpublic information about the publicly traded company Foundry Networks Inc. from Riley, an employee of Foundry. First, on July 16 2008, Riley allegedly told Teeple that Foundry had agreed to be acquired by Brocade for approximately $3 billion and that such acquisition would be announced on July 21, 2008. Teeple allegedly conveyed the information to Harden, Teeple's supervisor, but Artis nevertheless began buying Foundry stock and call options, and selling short Foundry put options — trades that reflected a positive view of the stock's future price movement. Five days later, when news broke of Brocade's agreement to acquire Foundry, Foundry's stock price increased significantly, generating profits and avoiding losses of over $21 million for Artis' hedge funds. According to the SEC, despite these facts, Harden did not inquire whether Teeple received material nonpublic information about the merger or whether his views about Foundry securities were based on such information. Three months later, Teeple obtained material nonpublic information concerning Foundry's ability to close the previously announced acquisition. Specifically, Riley informed Teeple that there were problems concerning the completion of the acquisition deal. Once again, Teeple conveyed the information to Harden. Artis, however, subsequently decreased its hedge funds' bullish position in Foundry stock. When Foundry announced a delay in the process, Foundry's stock dropped by more than 25 percent. However, because Artis had sold Foundry equity positions based on Teeple's recommendation, Artis' hedge funds avoided trading losses of approximately $4.3 million. On both trading occasions, notwithstanding the information provided by Teeple, Harden neither questioned Teeple about the source of his information nor asked the chief compliance officer (CCO) or any other colleagues at Artis to look into the matter. Artis and Harden also failed to increase their oversight of Teeple's information-gathering activities. As a result of the trades, Artis hedge funds profited and avoid losses totaling approximately $25.3 million. Artis also obtained additional profits of approximately $5.16 million attributable to this trading in Foundry securities. In addition, although Artis had written policies and procedures that prohibited the receipt and use of

material, nonpublic information, the firm failed to adopt policies or procedures to address the particular risk presented by Teeple's frequent interaction with contacts at public companies in whose securities Artis traded. For example, Artis did not require Teeple (who worked outside of Artis' offices) to report his interactions with employees of public companies, and it did not have policies to track or monitor these interactions. Furthermore, Artis failed to appropriately enforce its policies and procedures concerning the receipt and use of material nonpublic information. During the relevant period, Artis had a written policy that required employees to bring to the attention of the firm's CCO any potential material nonpublic information received from any source. During 2008, despite at least two instances in which Teeple provided Artis with information regarding Foundry prior to material announcements by the company, these events were not brought to the attention of the CCO.

Status: Artis Capital agreed to settle the SEC's charges by agreeing to pay disgorgement of $5.61 million plus interest of $1.13 milion and a penalty of $2.58 mllion. Harden agreed to pay a $130,000 penalty and agreed to a 12-month suspension from the securities industry.

In re MSC-BD LLC
Date: May 2, 2016
Agency: FINRA
Authority: Civil
Forum: FINRA Proceeding
Event: Settlement Reached

Summary: FINRA alleged, among other claims, that MSC-BD failed to establish a supervisory system and written supervisory procedures ("WSPs") reasonably designed to detect and prevent one of its representatives from causing the firm to participate in unlawful securities transactions. FINRA further alleged that MSC-BD failed to enforce an unwritten policy of placing issuer clients of the representative's Finder Platform (a platform through which the representative would find potential investors for microcap issuers) on MSC-BD's Restricted List upon the execution of consulting agreements between the issuer client and the finder platform. As a result, MSC-BD allegedly failed to maintain current restricted lists with respect to the issuer clients of the Finder Platform.

Status: On May 2, 2016, FINRA announced a settlement with MSC-BD pursuant to a letter of Acceptance, Waiver and Consent in which FINRA found that MSC-BD had violated NASD Rule 3010 by failing to establish the necessary procedures to detect unlawful securities violations and by failing to enforce a policy of placing issuer clients of the Finder Platform on the firm's Restricted List. Under the terms of the settlement, MSC-BD agreed to the imposition of a censure and a fine of $15,000.

3. Case in Which the Government's Motion to Stay Civil Discovery Was Denied

United States v. Davis, et al.
Date: Aug. 26, 2016
Agency: DOJ
Authority: Criminal
Forum: S.D.N.Y.
Event: Government's Motion to Stay Civil Proceedings Denied

Summary: The SEC charged William "Billy" Walters, a sports bettor, investor, and the CEO and chairman of the Walters Group, and former Dean Foods director Thomas Davis with insider trading. They allegedly operated a scheme in which Davis would leak material nonpublic information

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regarding Dean Foods to Walters, who in turn traded on it and shared it with the professional golfer Phil Mickelson, whom the SEC named as a relief defendant. According to the SEC's complaint, Walters was owed money by then-Dean Foods Company board member Davis. Davis regularly shared inside information about Dean Foods with Walters in advance of market-moving events, using prepaid cell phones and other methods in an effort to avoid detection. Among the various efforts made to avoid detection, Walters instructed Davis to refer to Dean Foods as the "Dallas Cowboys" during conversations. Furthermore, while Walters made millions of dollars insider trading using the confidential information, he provided Davis with almost $1 million and other benefits to help Davis address his financial debts. In addition, the SEC's complaint alleged that professional golfer Phil Mickelson traded Dean Foods' securities at Walters' urging and then used his almost $1 million of trading profits to help repay his own gambling debt to Walters. As a result of this scheme and based on the illegal tips received from Davis, Walters allegedly made $40 million. In a parallel action, the DOJ announced criminal charges against Walters and Davis.

Status: In the criminal case against Walters, the government requested a completed stay of discovery in the SEC's enforcement action against Walters. On Aug. 26, 2016, however, the court denied the government's request. According to the court, the government's evidence in support of the notion that Walters would engage in witness tampering was ambiguous and insufficient to justify a stay of the action. The court also noted that Walters is funding his defense personally and that the cost of doing so will increase if his attorneys cannot work on both cases at the same time. The court also cited Walters' business ties to the gaming industry and stated that tight industry regulations make the pending cases especially damaging and have caused business partners of Walters to sever ties with him. Accordingly, the court said that discovery could proceed usefully during the prosecution of the criminal case.

4. Insider Trading Developments in the United Kingdom

FCA v. Dodgson et al.
Date: May 9, 2016
Agency: FCA
Authority: Criminal
Forum: Southwark Crown Court
Event: Dodgson and Hind Convicted

Summary: The FCA alleged that Martyn Dodgson, the former managing director of Deutsche Bank and a former broker at Lehman Brothers, and Andrew (Grant) Harrison, a former Panmure Gordon corporate broker, passed inside information gleaned from their work on six stocks, including nCipher and BskyB, to Andrew Hind, an accountant and former finance director at Arcadia Group's Topshop, who then asked Iraj Parvizi and Ben Anderson (both day traders) to trade on his behalf. According to the FCA, Dodgson and Hind subsequently split the profits and generated £7.4 million in ill-gotten gains. The men employed military-grade encryption devices, pay-as-you-go mobile phones and Panamanian bank accounts to cover up the insider trading.

Status: On May 9, 2016, Dodgson and Hind were found guilty of insider trading. Dodgson was sentenced to four and a half years in prison and Hind was sentenced to three and a half years in prison.

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FCA v. Lyttleton
Date: Dec. 21, 2016
Agency: FCA
Authority: Criminal
Forum: Southwark Crown Court
Event: Lyttleton Convicted

Summary: According to the FCA, Lyttleton, a former Blackrock executive and investment manager, bought 170,000 shares in Encore Oil PLC in early October 2011, profiting from early knowledge of the company's takeover by Premier Oil PLC. Lyttleton then purchased 120 call options for Cairn Energy PLC on Nov. 4, 2011, trading on inside knowledge of an oil discovery the company had made in Greenland. According to the FCA, Lyttleton used a complex web of offshore accounts and companies to disguise what he had done, using a Panama-registered company beneficially owned by his wife to book the trades. Lyttleton booked £45,000 profit on the first trade and made a loss of £10,000 on the second trade when Cairn's oil discovery was found to be uncommercial.

Status: On Dec. 21, 2016, Lyttleton was sentenced to 12 months in prison. Lyttleton was also ordered to pay a £149,861 ($185,513) confiscation order and £83,225 in court costs within 28 days.

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Recent and Upcoming Legal Developments Affecting Employers

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Ian concentrates on executive compensation and employee benefits, with a focus on the employee benefit aspects of mergers and acquisitions and issues arising from the investment of pension plan assets. He represents both executives and companies with respect to the negotiation and drafting of executive employment agreements and advises as to the design and establishment of virtually all types of employee benefit arrangements ranging from cash incentive, equity, deferred compensation and change-in-control arrangements to broad-based retirement and welfare plans. He also advises clients on fiduciary and plan asset requirements of ERISA, including the structure and offering of various securities and securities products; the formation and ongoing compliance of private equity and hedge funds; the administration, management and investment of employee benefit plans; and compliance with ERISA's various prohibited transaction rules and exemptions.

Ian has been recognized as a leading employment and employee benefits attorney by *The Legal 500 United States* and *New York Super Lawyers*. *The Legal 500 United States* noted that he "operates at a very high level across many areas, but brings a particularly unique set of skills to ERISA Title I matters in his representation of private investment funds." Ian recently co-authored "Federal Court Finds Private Equity Funds Liable for Pension Liabilities of Portfolio Company," published in *Pratt's Journal of Bankruptcy Law*, and presented "The M&A Transactional Practice" at Practising Law Institute ERISA: The Evolving World Seminar. An adjunct professor at New York Law School, he is also a member of the Emory Law Alumni Board.

Ian earned his LL.M. from New York University School of Law and his J.D. from Emory University School of Law. He received his B.A. from Union College.

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Ron is co-head of Schulte Roth & Zabel's Employment & Employee Benefits Group. 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, nonsolicit, 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. Ron 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 employment and employee benefits lawyer, 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. Ron has also presented on recent employee benefits issues for investment managers, ERISA and withdrawal liability estimates. He is the co-author of "Federal Court Finds Private Equity Funds Liable for Pension Liabilities of Portfolio Company," published in *Pratt's Journal of Bankruptcy Law*, and "Update on the New Federal Overtime Regulations and the New York Minimum Wage," published in *Westlaw Journal – Employment*.

Ron received his J.D. from Columbia University Law School, 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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Phyllis 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 private equity 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 issues related to fund restructuring and secondary transactions. Recently interviewed by *Private Funds Management* in "Ringing the Changes," 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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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. With a focus on the investment management space, Holly drafts and negotiates employment agreements, separation agreements, data security and privacy policies and other employment-related agreements; advises employers on employment law compliance, best practices, human resources matters, hiring and termination, and litigation avoidance; and provides training and conducts investigations. She 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.

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 and is a co-author of *Hedge Funds: Formation, Operation and Regulation*, published by ALM Law Journal Press. Holly recently co-authored "Hedge Fund Employee Compensation," which appeared in *Practical Law*, and has contributed articles on arbitration-related topics to *New York Law Journal*. She was interviewed in "Strategies for Preventing and Handling Cybersecurity Threats from Employees," which appeared in *The Cybersecurity Law Report*, and she is also the author of "Effective Client Communication," which appeared in *Labor and Employment Client Strategies: Leading Lawyers on Preventing Litigation, Minimizing Risks and Dealing with Employee Legal Problems*. A much sought-after speaker, she recently served as a moderator for the NYU Center for Labor and Employment Law 68th Annual Conference on Labor.

Holly earned a J.D. from the University of Virginia School of Law and a B.A. from Emory University.

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Recent and Upcoming Legal Developments Affecting Employers

I. Statutory and Regulatory Developments Require Firms to Rethink Their Agreements with Employees

A. There are recent statutory developments in Connecticut and New York affecting employment agreements. If not carefully drafted, confidentiality provisions may run afoul of these statutes.

1. Connecticut's Statute: On July 1, 2015, Connecticut enacted a law prohibiting employers from barring discussions about wages or punishing employees for discussing wages. Connecticut's law creates a private right of action and does not exclude supervisory employees.

2. New York's Statute: On Oct. 21, 2015, New York enacted a similar law restricting employers from preventing employees, supervisory and nonsupervisory, from discussing information on wages. New York's law, however, permits an employer, in a written policy provided to all employees, "reasonable workplace and workday limitations on time, place and manner" of such discussion. Employer policies must be consistent with standards promulgated by the labor commissioner.

B. The National Labor Relations Board ("NLRB") has also taken action that affects confidentiality agreements.

1. The NLRB filed a complaint against a hedge fund in June 2016. It was settled confidentially in November 2016. The hedge fund was alleged to have an employment agreement and policy that ran afoul of Section 7 of the National Labor Relations Act: The right of employees to engage in "concerted activity ... for the purpose ... [of] mutual aid and protection."

2. The NLRB challenged five different provisions in the hedge fund's employment agreement:

(a) Confidentiality of Terms of Employment: "You agree that the terms of your employment with [the firm] are confidential."

(b) Non-disparagement: "Employees 'may not disparage [the firm] and/or its present or former affiliates, directors, officers, shareholders, employees or clients, whether directly or indirectly, in any manner whatsoever (whether related to [the firm] or otherwise) except as required by law.'"

(c) Protection of Confidential Information: "Confidential Information" is defined as "any non-public information relating to the business or affairs of [the firm] or its affiliates, or any existing or former officer, director, employee or shareholder of [the firm]," including employee "compensation" information; and information regarding "[the firm's] organizational structure (including the allocation of responsibilities and general construction of [the firm's] departments, businesses, subsidiaries and employees assigned to them)."

(d) Arbitration Provision Barring Class Actions: "Prohibits employees from pursuing class or collective action, and requires that employees pursue disputes with [the firm] in arbitration on an individual basis."

(e) Non-publicity: "Employees are prohibited from disclosing 'confidential information' to 'any media or business, outlets, or other endeavors that publish, broadcast, distribute, or otherwise disseminate information in any format, including but not limited to books, newspapers,

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magazines, journals, websites, blogs, social media outlets, television and radio stations, and streaming media outlets.'"

C. The SEC recently challenged employment agreements that allegedly violated SEC Rule 21F-17.

1. Section 21F of the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2011 ("Dodd-Frank") provides monetary awards to whistleblowers who provide original information that leads to a successful SEC enforcement action and prohibits employers from retaliating against such employees. Although adopted in 2011, the first enforcement action was publicized in 2015 against KBR.

2. Rule 21F-17 provides that "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." Although adopted in 2011, the first enforcement action under Rule 21F-17 was publicized in 2015 against KBR.

   (a) KBR had a confidentiality agreement that employees were required to sign before an internal investigatory interview and required the employees to get authorization from the company's legal department before disclosing information outside of the company. The SEC determined that the provision undermined the purpose of Section 21F and violated Rule 21F-17.

   (b) KBR was required to amend its agreement to expressly provide that nothing in the agreement prohibits an employee from "reporting possible violations of federal law or regulation to any governmental agency or entity" (including the SEC) or from "making other disclosures that are protected under the whistleblower provisions of federal law or regulation."

3. Several publicized enforcement actions in 2016 involved separation agreements.

   (a) The SEC challenged a confidentiality provision that prohibited employees from disclosing confidential information unless "compelled by law and after notice to" the employer.

   (b) The SEC challenged a non-disparagement provision that specifically prohibited former employees from communicating disparaging information about the company to the SEC.

   (c) The SEC challenged provisions in which the employees waived or acknowledged they were waiving the right to any monetary recovery in connection with a complaint filed with a government agency.

   (d) The SEC determined that the provisions undermined the purpose of Section 21F and violated Rule 21F-17.

   (e) The employers were ordered to contact former employees who had signed separation agreements since Aug. 12, 2011 (the date Rule 21F-17 became effective) and to provide them with a copy of the SEC Order and a statement that the employer "does not prohibit former employees from:

      (i) [P]roviding information to, or communicating with, Commission staff without notice to the Company; or

      (ii) [A]ccepting a whistleblower award from the Commission pursuant to Section 21F of the Exchange Act."

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4. On Oct. 24, 2016, the Office of Compliance Inspections and Examinations ("OCIE") sent out a risk alert regarding compliance with Rule 21F-17.

    (a) OCIE is reviewing and examining registrants' compliance with rules impacting whistleblowers and potential whistleblowers.

    (b) In reviewing registrants' compliance with Rule 21F-17, OCIE's staff is analyzing a variety of documents, including: (1) compliance manuals; (2) codes of ethics; (3) employment agreements; and (4) severance agreements.

    (c) OCIE is analyzing whether these documents contain provisions similar to those in agreements that the Commission has found to violate Rule 21F-17, including provisions that:

        (i) "[P]urport to limit the types of information that an employee may convey to the Commission or other authorities"; and

        (ii) "[R]equire departing employees to waive their rights to any individual monetary recovery in connection with reporting information to the government."

II. Protecting Your Firm's Confidential Information with Restrictive Covenants

A. Noncompetition agreements and other restrictive covenants are becoming increasingly common. There are a number of issues that arise in the context of drafting and attempting to enforce noncompetition and other restrictive covenant agreements especially in the private funds context.

1. The law with respect to covenants not to compete varies from state to state. Some states, like California, have laws that prohibit an employer's ability to impose and enforce noncompetition agreements, except in certain circumstances. *See* Cal. Bus. & Professions Code Section 16600.

    California has recently enacted legislation to bolster its statutory prohibition of noncompetition agreements. California Labor Code Section 925 ("Section 925") prohibits employers from requiring an employee who primarily lives and works in California to enter a contract that requires the employee to litigate with his or her employer outside of California or be deprived of the protections of California law.

    (a) Section 925 only applies to contracts entered into after Jan. 1, 2017. Section 925 also does not apply if the employee is represented by legal counsel.

    (b) The law was drafted as a response to concerns over employers imposing choice of law and forum selection provisions on California residents; those who advocated for the law characterized these provisions as attempts by employers to evade California law. *See* Cal. Bus. & Professions Code Section 16600.

2. In general, restrictive covenants may be used to protect an employer's legitimate business interests, such as extraordinary employee services and trade secrets. Trade secrets can include, but are not limited to, confidential customer information and, in some situations, customer relationships.

3. In evaluating whether a "trade secret" is protectable, New York courts analyze the following factors:

    (a) The extent to which it is known by employees who do not need to know and others involved in the employer's business;

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(b) The measures the employer takes to guard the information's secrecy;

(c) The value of the information to the employer and its competitors;

(d) The amount of money or effort that the employer expended in developing the information; and

(e) The ease or difficulty with which the information could be properly acquired or duplicated by others. *See Ivy Mar Co. v. C.R. Seasons Ltd.*, 907 F. Supp. 547, 554 (E.D.N.Y. 1995).

Connecticut courts look at the same factors, as well as "the extent to which the information is known outside the employer's business." *See Robert S. Weiss & Assoc., Inc. v. Wiederlight*, 208 Conn. 525, 538 (1988).

4. New York courts historically have been reluctant to enforce restrictive covenants in light of the strong public policy in favor of free competition and against restricting an individual's ability to earn a livelihood. Nonetheless, "properly scoped noncompetition agreements are enforceable to protect an employer's legitimate interests so long as they do not militate against public policy." *See Int'l Bus. Mach. Corp. v. Visentin*, No. 11 Civ. 399 (LAP), 2011 WL 672025, at *8 (S.D.N.Y. Feb 16, 2011) (citing *BDO Seidman v. Hirshberg*, 93 N.Y.2d 382 (1999)).

(a) A New York federal court addressed the extent of trade secret protection in a case in which the court denied IBM's attempt to restrain one of its former executives, Giovanni Visentin, from working for an IBM competitor, HP, for one year. *See Visentin*, 2011 WL 672025.

(b) In seeking a preliminary injunction, IBM alleged that Mr. Visentin had acquired trade secrets, including: strategic initiatives in cloud computing, acquisition plans, pricing strategies, operational finances, the identity of troubled accounts, competitive strategies with HP and client "pipeline" information. The court addressed each of IBM's alleged trade secrets and found that Mr. Visentin only had generalized information and that IBM had failed to provide any specific examples of how Mr. Visentin's generalized knowledge could be used at HP to IBM's detriment. The court, therefore, denied IBM's motion for a preliminary injunction.

(c) The lesson for employers from the *Visentin* case is that, to prevail, they will need to explain the precise trade secret information at issue and the adverse impact the disclosure of that information will have on the employer's business.

B. There has been an increase in legislative efforts aimed at limiting the use of noncompetition agreements.

There is proposed legislation in New York that will limit the use of noncompetition agreements. The bill, proposed by New York Attorney General Schneiderman:

1. Bans the use of noncompetition agreements for any employee earning below the salary threshold as set by N.Y. LAB. Law § 190(7) (currently $900 per week);

2. Prohibits noncompetition agreements that are broader than needed to protect the employer's trade secrets or confidential information;

3. Mandates that noncompetition agreements be provided to employees before a job offer is extended;

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4. Requires that employers pay employees additional consideration if they sign noncompetition agreements;

5. Limits the permissible time duration for noncompetition agreements; and

6. Creates a private right of action, including liquidated damages for violations.

C. There has also been unprecedented regulatory action by New York Attorney General Schneiderman against companies that imposed noncompetition agreements on a broad range of employees. Three actions have resulted in settlements:

1. Examination Management Services Inc. ("EMSI"), a nationwide medical information services provider, had noncompetition agreements that prohibited all employees from working for competitors after leaving the company, regardless of whether they had access to trade secrets. A former EMSI employee filed a complaint after a prospective employer refused to hire the former employee when it discovered the EMSI noncompetition agreement.

   (a) Under the settlement agreement, EMSI will no longer require New York employees other than "top executives such as directors and officers" to sign noncompetition agreements.

   (b) Pursuant to the settlement agreement, EMSI notified current employees and former employees who left within the last nine months (the restricted period under the agreement) that the noncompetition agreement was no longer in effect.

2. Law360 owned by Portfolio Media, Inc. ("Law360") had noncompetition agreements with a majority of its employees. The agreements mostly covered editors, reporters and researchers. A former employee would be banned from working for "any media outlet that provides legal news" for one year after termination of employment.

   (a) Under the settlement agreement, editorial employees will no longer be required to sign noncompetition agreements "except for a small number of top executives."

   (b) Under the settlement agreement, Law360 agreed to notify all current and former employees who left within the past year (the restricted period under the agreement) that the noncompetition agreements were no longer in effect.

3. Jimmy John's Gourmet Sandwiches ("Jimmy John's"), a sandwich franchisor, included sample noncompetition agreements in hiring packets sent to franchisees. The sample noncompetition agreements were intended for "sandwich makers" and "delivery drivers," who were prohibited for two years after leaving a job with a franchisee, from working at any establishment within two miles that made more than 10 percent of its revenue from sandwiches.

   (a) Under the settlement agreement, Jimmy John's agreed to stop including sample noncompetition agreements, and also agreed to inform franchisees "that the Attorney General has concluded the non-compete agreements are unlawful and should be voided."

   (b) Franchisees that had been using the noncompetition agreements promised to void past agreements and discontinue their use.

4. Attorney generals of other states have also challenged noncompetition agreements. For example, Illinois' Attorney General Lisa Madigan reached a similar settlement with Jimmy John's.

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III. Enforcement Mechanisms and Remedies for Breaches of Your Agreement's Restrictive Covenants

A. Generally, restrictive covenants in New York will be enforced when necessary to prevent a former employee from engaging in unfair or illegal competition through the disclosure or use of trade secrets or confidential information.

1. To be enforced, restrictive covenants must be reasonable in time, duration and scope. The case law concerning restrictive covenants is highly fact specific. Generally, restrictive covenants in New York will be enforced only:

    (a) To the extent necessary to prevent a former employee from engaging in unfair or illegal competition through the disclosure or use of trade secrets or confidential information; or

    (b) When the employee's services are unique or extraordinary. *See Reed, Roberts Assoc., Inc. v. Strauman*, 40 N.Y.2d 303, 307, 353 N.E.2d 590, 593, 386 N.Y.S.2d 677, 679 (1976); *Ivy Mar Co. v. C.R. Seasons Ltd.*, 907 F. Supp. 547, 554 (E.D.N.Y. 1995).

2. Injunctive relief tends to be the favored remedy because damages are difficult to ascertain with the degree of certainty that is required for an award. *See Estee Lauder Companies Inc. v. Batra*, 430 F. Supp. 2d 158 (S.D.N.Y. 2006).

    (a) An employer's remedies are not limited to injunctive relief, however. Monetary damages are available. An employee's breach of a noncompetition agreement is properly measured by lost profits. *See, e.g., Earth Alterations, LLC v. Farrell*, 800 N.Y.S.2d 744 (2d Dep't 2005).

    (b) In New York, an employer seeking an injunction to enforce a noncompetition agreement must prove:

        (i) A likelihood of success on the merits;

        (ii) Irreparable injury to the employer if injunctive relief is not granted; and

        (iii) The balance of hardships favors the employer. *See Visentin* (citing *Lusk v. Vill. of Cold Spring*, 475 F.3d 480, 485 (2d Cir. 2007).

    (c) Employers should be careful when considering hiring a prospective employee who has an enforceable noncompetition agreement with a former employer. To make out a valid claim for tortious interference with a contract, the former employer must demonstrate:

        (i) Existence of a valid contract between the employee and the former employer;

        (ii) The competing employer's knowledge of the restrictive covenant. *See Novus Partners, Inc. v. Vainchenker*, 32 Misc.3d 1241(A) (Sup. Ct. N.Y. County 2011 (holding that a former employer adequately alleged that the competing employer had knowledge of prospective employee's noncompetition agreement);

        (iii) Intentional procurement by the competing employer. *See Innovative Networks, Inc. v. Young*, 978 F. Supp. 167 (S.D.N.Y. 1997) (holding that the former employer must demonstrate that employee would not have violated restrictive covenant but for the defendant); and

        (iv) Actual breach of the noncompetition agreement and damages.

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B. Congress enacted the Defending Trade Secrets Act ("DTSA") in May 2016. The DTSA provides employers with a private cause of action for misappropriation of trade secrets in federal court. The private cause of action does not preempt or displace state law governing the protection of trade secrets.

1. The employer, owning a trade secret "related to a product or service used in, or intended for use in, interstate or foreign commerce," has the right to commence a civil action in federal court if such trade secret is misappropriated or if misappropriation is threatened. There are three principal remedies under the DTSA:

   (a) *Ex Parte* Seizures: In "extraordinary circumstances," a court may, upon *ex parte* application, "issue an order providing for the seizure of property necessary to prevent the propagation or dissemination of the trade secret that is the subject of the action." Before issuing such a seizure order, an applicant must demonstrate to the court that the applicant otherwise would suffer irreparable and immediate injury.

   (b) Injunctions: An employer may seek an injunction to prevent actual or threatened misappropriation. The DTSA places certain limitations on such injunctions. Most importantly, they may not "prevent a person from entering into an employment relationship." Further, any conditions on employment cannot be based on a person's mere knowledge of trade secrets (unlike employment conditions imposed under state law based on the inevitable disclosure doctrine). Rather, employment restrictions must be based on "evidence of threatened misappropriation."

   (c) Damages: An employer may seek damages for actual loss, plus any unjust enrichment in excess of actual loss, caused by the misappropriation of a trade secret. Alternatively, an employer may collect a reasonable royalty for an unauthorized disclosure or use of a trade secret.

2. The DTSA provides employers with greater resources to protect trade secrets. Because the private cause of action under the DTSA will not preempt state law, employers will be able to pursue claims under both federal and state law. They will have access to federal courts to pursue those claims.

3. At the same time, the DTSA imposes additional burdens on employers. Employers will need to make sure that their employment contracts contain the proper notifications as required by the DTSA, which includes providing employees notice of the immunity and anti-retaliation provisions of the DTSA.

   For example, the DTSA provides immunity from civil and criminal liability under federal or state trade secret law for individuals who disclose trade secrets in confidence to federal, state or local government officials, or to attorneys, in each case "solely for the purpose of reporting or investigating a suspected violation of law," or in court filings made under seal.

C. A forfeiture-for-competition provision is a common way to disincentivize competition after termination of employment.

1. The "employee choice" doctrine is based on the assumption that one who elects to leave an employer makes a knowing, informed choice between forfeiting a certain benefit by competing with the employer or retaining the benefit by refraining from competition with the employer. "New York courts will enforce a restrictive covenant without regard to its reasonableness if the employee has been afforded the choice between not competing (and thereby preserving his benefits) or

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competing (and thereby risking forfeiture)." *See Lucente v. Int'l Bus. Mach., Corp.*, 310 F.3d 243, 254 (2d Cir. 2002) (holding that the employee choice doctrine can apply to deprive an employee of a future benefit or to recover a benefit already paid to the employee).

2. A forfeiture-for-competition provision does not prohibit competition. Rather, it provides that if the former employee does compete, he or she will forfeit benefits or payments to which he or she would otherwise be entitled.

3. It is settled in New York that an employer can rely on the doctrine only if: (1) the employer "can demonstrate its continued willingness to employ the party who covenanted not to compete"; or (2) the employee is not discharged without cause. *Id; see also*, *Gismondi, Paglia, Sherling, M.D., P.C. v. Franco*, 104 F. Supp. 2d 223, 233 (S.D.N.Y. 2000); *In re UFG Intern., Inc. v. DeWitt Stern Group, Inc.*, 225 B.R. 51, 55 (S.D.N.Y. 1998) ("[A]n employee's otherwise enforceable restrictive covenant is unenforceable if the employee has been terminated involuntarily, unless the termination is for cause"). *See also Post v. Merrill Lynch*, 48 N.Y.2d 84 (1979) (holding forfeiture-for-competition clauses unenforceable in the event of an involuntary "without cause" employment termination).

4. Employers may want to consider crafting a forfeiture-for-competition clause (sometimes couched as a "good leaver" provision), which permits employees who resign, but do not compete (or engage in other detrimental conduct), before deferred payments are due and/or become vested will be able to receive those payments. If, however, they compete or engage in detrimental conduct before the payments vest and/or become vested, the payments are forfeited. The payments may be substantial enough effectively to deter the employee from competing until they are paid.

IV. A Legal Perspective on Trends in Compensation

A. The postponement or deferral of employees' compensation is a common compensation tool among all types of employers, particularly for asset managers. Its use includes:

1. Incentivizing employees over a multiple-year period;

2. Retaining employees by conditioning payment on continued employment and/or performance;

3. Providing employers with a means to incentivize employees to avoid "bad behavior" (such as violating firm policies and legal requirements) during employment; and

4. Providing employers with a "self-help" means to help impose adverse consequences on an employee who does not satisfy his or her post-obligations to the employer without the need of a court.

B. With the loss of the traditional offshore fund deferred fee arrangements as a result of Sections 409A and 457A of the Internal Revenue Code (the "Code"), the alternatives for postponing "unvested" employee compensation have become more limited. Postponing compensation has been accomplished through two approaches:

1. Postponement on a pre-tax or tax-deferred basis of a portion of an employee's bonus, which requires the firm's partners to pay tax on the amount it is not currently paying; or

2. An after-tax mandatory reinvestment by the employee of a portion of his or her bonus in the funds managed by the firm (i.e., the firm receives a tax deduction and the bonus is taxable to the employee).

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C. Traditionally, certain management firms organized as a partnership incentivized and rewarded successful employees with admission to the partnership. Where employees are granted partnership interests in a firm, it is important to consider how it will affect their status as employees. In most cases, regardless of the size of the partnership interest or whether a capital or profits interest, the individual will need to be treated as a partner for tax and employee benefit plan purposes. In May 2016, the IRS issued temporary regulations clarifying that an individual cannot be both a partner of a partnership as well as an employee of the partnership's subsidiary if that subsidiary is a tax disregarded entity (i.e., an entity that is essentially ignored for tax purposes). The regulations became effective on Aug. 1, 2016.

1. Note, this issue is not relevant where an individual is awarded an equity interest (e.g., a carried interest) in another entity, such as a general partner of a fund or a fund.

2. The consequence of being considered a partner, rather than an employee of an entity, is significant.

(a) Amounts received by a partner for services are not subject to federal income tax withholding; instead, the partner is responsible for the payment of his or her taxes.

(b) Instead of FICA (Social Security and Medicare taxes), which is generally split evenly between an employer and employee, a partner is solely responsible for the payment of self-employment taxes (SECA), which parallels FICA.

(c) A partner is exempt from federal unemployment taxes and is not eligible to make a claim for unemployment benefits.

(d) A partner can participate in employer group health plans but must pay premiums with after-tax dollars and is not eligible to participate in an employer cafeteria plan, dependent care flexible spending account or health flexible spending account.

V. Other Statutory and Regulatory Developments Impacting Your Employees' Compensation

A. A bill pending New York City Council approval will prohibit employers from asking job applicants about their salaries or using volunteered information if they obtain it.

The impetus for this proposed law is gender equality. According to the New York City Council, adopting measures like this bill can reduce the likelihood that women will be prejudiced by prior salary levels and help break the cycle of gender pay inequality.

B. A new Department of Labor ("DOL") overtime rule was blocked by a federal judge in November 2016. The DOL's final rule increased the minimum salary level necessary to qualify for the executive, administrative and professional exemptions under the Fair Labor Standards Act.

1. In May 2016, the DOL issued a final rule that increased the salary level for the executive, administrative and professional exemptions from $455 per week ($23,660 per year) to $913 per week ($47,476 per year) and the minimum salary level for the exemption for "highly compensated employees" from $100,000 to $134,004 per year. The final rule did not change the duties tests for the executive, administrative and professional exemptions or the minimal duties test for "highly compensated employees."

2. The new rule would have gone into effect on Dec. 1, 2016. A federal court in Texas issued a nationwide injunction, preventing the rule from taking effect on Dec. 1, 2016. However, on the same day the new rule was set to go into effect, the DOL filed a notice of appeal. The Fifth Circuit agreed to accelerate the DOL's appeal. It will not be decided until after Jan. 20, 2017.

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3. For New York employers, the injunction means that, for the time being, the minimum salary necessary to qualify for the "highly compensated employee" exemption will remain at $100,000 and at $455 per week for the professional exemption. New York, however, has always required a higher minimum salary threshold for employers that use the executive and administrative exemptions.

4. In conjunction with New York's minimum wage increase that took effect on Dec. 31, 2016, the New York State Department of Labor recently increased the minimum salary thresholds for such exemptions. Similar to the minimum wage increases, the salary thresholds depend on employer size and location.

   Large employers in New York City (11 or more employees):

   (a) $825 per week ($42,900 per year) on and after Dec. 31, 2016.

   (b) $975 per week ($50,700 per year) on and after Dec. 31, 2017.

   (c) $1,125 per week ($58,500 per year) on and after Dec. 31, 2018.

C. New York Labor Law § 195-4.5(e)-(g) prohibits an employer from deducting an employee's wages, including for the purpose of assessing penalties to employees who cause their firms to incur regulatory fines. State laws are an important consideration in designing and enforcing clawback provisions. Clawbacks involve policies in which compensation is recouped by the employer in the event that an employee violates the law, a contract or a policy.

1. New York, for example, prohibits employers from deducting "wages" or requiring that employees pay back their employer for fines they incurred. New York Labor Law § 195-4.5(e)-(g) prohibit an employer from deducting an employee's wages including "repayment of employer, including … fines or penalties for tardiness, excessive leave, misconduct … ."

   (a) Wages are defined under N.Y. Labor Law § 190(1) as the "earnings of an employee for labor services rendered, regardless of whether the amount of earnings is determined on a time, piece, commission or other basis. The term 'wages' also includes benefits or wage supplements." The terms "benefits or wage supplements" is defined as "reimbursement for expenses; health, welfare and retirement benefits; and vacation, separation or holiday pay." N.Y. Labor Law § 198-c.

   (b) "Incentive compensation … not included in the definition of 'wages' under Labor Law § 190(1)" *See Marsh v. Prudential Sec.*, 1 N.Y.3d 146, 154 (2003). This includes deferred equity based compensation such as unvested, contingent rights to equity-based compensation. *See Guiry v. Goldman, Sachs & Co.*, 31 A.D.3d 70 (1st Dept. 2006).

   (c) Another exception to the broad definition of "wages" would be a truly discretionary bonus. Employers must consider what forms of incentive compensation should be included in their clawback policy so as not to violate state law.

2. Employers should consider the various tax implications in designing and implementing clawbacks.

   (a) Under the "Claim of Right Doctrine," if a taxpayer receives compensation that he or she is free to use and dispose of, he or she must pay taxes on this income despite it being subject to some restriction (e.g., violating a clawback provision) that would force the employee to pay back the income in the future.

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(b) Under Section 1341 of the Code, a taxpayer can claim a deduction the following year if the taxpayer establishes that: (i) the income was included the previous year; (ii) after the close of the prior year, he or she did not have an unrestricted right to the income; and (iii) he or she is eligible to a deduction in excess of $3,000 under another section of the Code. However, the "Claim of Right Doctrine" is generally difficult to assert in the context of a clawback.

(c) Because of the adverse tax consequences (on top of the detriment to the employee of repaying the compensation), many employers require repayment of only the after-tax value of the compensation.

(d) Clawback provisions must be designed to avoid violating the strict rules regarding deferred compensation imposed by Code Section 409A ("409A"). 409A prohibits accelerating deferred compensation. If deferred compensation is distributed early to the employee or offset for purposes of satisfying the employee's obligation to repay other monies, this distribution will likely be deemed an "acceleration" or impermissible offset that will violate 409A. 409A provides that a 20-percent penalty or offset is triggered against an employee on all deferrals under the plan.

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Designing and Launching 1940 Act Regulated Funds: A Practical Guide

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Hedge Funds
Regulated Funds

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Pamela focuses on the representation of investment companies, business development companies, investment advisers and investment banking institutions in connection with the structuring, formation, funding and operation of investment products and services, including mutual funds, closed-end investment companies and registered hedge funds. She also advises clients on a broad range of regulatory and compliance matters associated with investment companies, investment advisory, brokerage, securities custody and transfer agent services.

A member of the Women's Investment Management Forum, Pamela is a contributor to *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and co-author of "SEC Proposes Rule Governing the Use of Derivatives and Short Sales by Registered Investment Companies and Business Development Companies," published by *Westlaw Journal — Derivatives*. She recently addressed what alternative investment managers need to know about managing 1940 Act funds and the new 1940 Act Rule 22e-4 at SRZ webinars.

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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, and in connection with the development of other types of investment-related products and services. 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 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. A frequent speaker and author on issues related to investment funds and investment advisers, 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.

After receiving his B.S. from the Wharton School of the University of Pennsylvania, Ken went on to obtain a J.D. from the James E. Beasley School of Law at Temple University, where he was a member of the Law Quarterly, and an LL.M. from Georgetown University Law Center.

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John 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 ranging from SEC regulations and disclosure obligations to public and private capital raising structures, 1940 Act regulated funds and M&A issues. Recently, John addressed what alternative investment managers need to know about managing 1940 Act regulated funds at an SRZ webinar.

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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Designing and Launching 1940 Act Regulated Funds: A Practical Guide

I. 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 Investment Company Act of 1940 (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. Unlike a private investment fund, 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" and may use advertising and 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 the 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 (collectively, "regulated funds") may seek to qualify as regulated investment companies ("RICs") under Subchapter M of the Internal Revenue Code of 1986 (the "Code"). This enables them generally to avoid entity-level taxation and to provide simplified tax reporting to investors on Form 1099.

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6. Attachment A (Comparison of U.S. Alternative Fund Structures) compares 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 of a registered fund by employee benefit plans, the 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 whether a registered fund's use of commodity interests satisfies the de minimis tests, commodity interests used for "bona fide hedging" purposes need not be considered.

3. Financial Industry Regulatory Authority ("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.

II. 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. Types of registered alternative funds include, among others: 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 ("ETFs"). 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 the fund's adviser and prospective distribution partners.

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(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 fund is not subject to this requirement and thus has greater control over the timing of cash flows to/from the fund. A closed-end structure is required for funds that make significant investments in illiquid securities, but may also be desirable for alternative investment strategies where dealing with daily cash flows might adversely affect investment performance or where the fund's adviser wants to provide limited liquidity similar to the liquidity that is made available to investors in its private funds.

(d) Because shares of open-end funds are redeemable and such funds are generally required by Section 22(e) of the 1940 Act to pay redemption proceeds within seven days, the Securities and Exchange Commission (the "SEC") has taken the position that an open-end fund may not purchase an illiquid security if, as a result of such purchase, more than 15 percent of the fund's net assets would be invested in illiquid securities. This position, with some modification, has now been codified by Rule 22e-4, which was recently adopted by the SEC. *See* IV.H. below. Thus, 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) may need to be structured as closed-end funds.

(e) The requirements of Rule 22e-4 may further limit the types of investment programs available to open-end funds.

(f) Although closed-end funds issue 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 be provided with liquidity similar to the liquidity of an investment in a private equity fund (by making distributions to investors only as the fund's investments are sold or become liquid).

(g) Alternatively, 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 to limit its investors to "accredited investors." In order to pay performance-based compensation, the fund would need to limit its investors to "qualified clients." *See* II.F below.

2. Non-publicly traded closed-end funds may 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 generally are repurchased based on the net asset value of the interests, determined as of a specified valuation date.

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(a) Funds that do not rely on Rule 23c-3 cannot commit to make repurchase offers in specified amounts or at specified periodic intervals. However, such a fund may establish a program under which it makes repurchase offers on a periodic basis (e.g., quarterly), subject to the approval of each such offer 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, semiannually 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 such a fund must not be redeemable or readily tradable. Semiannual offers, and quarterly offers with a notice requirement of 65 days, are typically viewed as acceptable in this regard.

3. The nature of prospective investors 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 nontraded closed-end funds (as well as public offerings by other types of closed-end funds and open-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 of the fund are not subject to decrease as a result of redemptions of shares or withdrawals of capital).

2. Publicly traded closed-end funds are often used by asset managers in lieu of a BDC structure (which is further described in III.E. below) because such funds can invest in non-U.S. companies and make other investments that would be considered "bad" assets for a BDC.

3. As a practical matter, the adviser of a publicly traded registered fund cannot receive performance-based compensation. *See* II.F. below. However, unlike 1940 Act registered funds, BDCs (including publicly traded BDCs) may pay performance-based fees, without having to restrict their investors to qualified clients. *See* II.E.1.(c) below. In addition, both registered funds and BDCs may pay fees computed as a percentage of their income.

D. Open-end Funds

1. In recent years, 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 who are each responsible for managing a "sleeve" of a single fund investment portfolio.

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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).

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 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. Most ETFs are 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 shares of an ETF to trade at prices that closely track the net asset value of the ETF's shares.

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

E. Business Development Companies

1. Characteristics of BDCs

    (a) A BDC is a closed-end investment management 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. 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 can access public capital markets.

    (b) Shares of a BDC may be offered publicly (in which case such shares may be listed for trading on a securities exchange) or may be offered in a private placement. Privately offered BDCs may only be sold to accredited investors. Private BDCs are often 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 public offering. BDCs following this model typically draw down capital via capital calls, similar to a private equity fund. A private BDC will generally target a future initial public offering and exchange listing.

    (c) BDCs are permitted by Section 205 of the Advisers Act to pay performance-based fees based on capital gains similar to private funds without limiting their shareholders to qualified clients. However, any performance fee based on capital gains cannot exceed 20 percent of the BDC's realized capital gains, net of realized losses and unrealized capital depreciation. Like registered investment companies, BDCs may also pay asset-based advisory fees.

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(d) In exchange for greater regulatory flexibility, a BDC must invest 70 percent of its assets in "good" BDC assets. Generally, such "good" or eligible assets are securities of 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.

(e) BDCs may issue debt securities as well as other senior securities. A BDC issuing debt or other senior securities must comply with an asset coverage requirement under which it is required to have at least a 200-percent asset coverage ratio (total assets to debt/senior securities). This asset coverage requirement is less stringent than the asset coverage requirement applicable to borrowings by registered funds. *See* IV.C. below.

(f) A BDC may issue convertible securities, including options, warrants and rights, subject to the receipt of shareholder approval to do so and provided that common stock underlying such convertible securities does not, in the aggregate, exceed 25 percent of the BDCs outstanding shares.

(g) 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.

(h) 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. If a BDC is taxed as a RIC, tax-exempt investors may invest directly in the BDC and need not invest in the BDC through an offshore blocker. *See* III.C below.

2. Benefits of BDC Status

(a) 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. Also, because a BDC (unlike a private investment fund) can make a public offering, a BDC can use advertising in marketing its shares and sell its shares to investors who are not accredited investors.

(b) A BDC can charge a performance-based fee without limiting its investors to qualified clients. *See* II.E.1(c) above.

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

(d) In certain respects, BDCs have greater flexibility under the provisions of the 1940 Act regulating transactions with affiliates.

3. BDC Management

(a) 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.

(b) A BDC must "make available" to its investee companies "significant managerial assistance." This requirement will be met if the BDC offers to provide to an investee company (and, if accepted, does provide) significant guidance and counsel concerning the management, operations, or business objectives and policies of the investee company. The requirement can also be met if the BDC exercises a controlling influence over the management or policies of an investee company (or exercises such influence as part of a control group).

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(i) Investee companies typically do not accept offers from BDCs to provide managerial assistance.

(ii) A BDC may receive compensation for providing these services.

4. Other Regulatory Considerations

(a) 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). Year-end financial statements of a BDC are required to be audited. Quarterly and annual financial statements are subject to Sarbanes-Oxley certifications. BDCs also have ongoing 8-K reporting obligations and must disclose certain material corporate events promptly on Form 8-K.

(b) 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* IV.E below.

F. Performance-based Fees/Allocations

1. A registered fund that pays compensation to its investment adviser based on capital gains (other than a fulcrum fee) cannot be publicly traded because such compensation may be paid only if all investors in the fund are "qualified clients" and there presently are no mechanisms available to restrict ownership of the fund's shares to such investors.

2. However, a registered fund can have a fee structure that is similar to that of a private investment fund (e.g., an asset-based management fee and an incentive allocation or incentive fee based on the fund's net investment income, and realized and unrealized capital gains) if interests in the fund are not publicly traded and 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) As a result of 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 (iii) 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 an underlying fund relying on Section 3(c)(1) are qualified clients.)

3. Section 205(b)(2) of the Advisers Act permits the adviser of a registered fund to receive performance-based compensation that is determined 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.

Fees based on a percentage of the net investment income of a fund are also permissible.

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III. Forming a Regulated Fund

A. Corporate Formation

1. Most registered funds and BDCs are organized as corporations, statutory trusts or business trusts. Privately offered closed-end funds and BDCs are sometimes organized as limited liability companies ("LLCs") or limited partnerships.

   (a) Corporations remain attractive because of the protection from liability afforded to shareholders. The venues of choice for corporations are Delaware and Maryland. The corporate laws of these states include provisions that provide greater flexibility to registered funds than to ordinary corporations regarding certain matters.

   (b) Statutory trusts and business trusts are unincorporated associations that are governed by boards of trustees. Like corporations, statutory trusts and business trusts protect shareholders from liability. Most registered funds that choose the trust form are organized in Delaware or Massachusetts.

   (c) An LLC is a hybrid form of business entity that combines corporation-style limited liability with partnership-style flexibility. The owners of an LLC are "members," rather than shareholders or partners. Registered funds taxable as partnerships are frequently organized as LLCs.

B. Registration Under the 1940 Act and 1933 Act

1. Registration Statements

   (a) Open-end funds and closed-end funds register under the 1940 Act by filing Form N-8A (a notification of registration).

   (b) Open-end funds are required to file 1940 Act registration statements with the SEC on Form N-1A.

   (c) Closed-end funds are required to file 1940 Act registration statements with the SEC on Form N-2.

   (d) Forms N-1A and N-2 are also used to register shares of a fund under the 1933 Act to enable a public offering.

   (e) A BDC must file a Form N-54A (a notification of its intent to be subject to Section 55 through 65 of the 1940 Act) and a registration statement on Form N-2.

   (f) A public offering of a fund's shares cannot commence until its registration statement under the 1933 Act becomes effective. As a matter of practice, a 1933 Act registration statement does not become effective until it is declared effective by the SEC staff. If a fund's shares are privately offered, the fund can commence the offering of its shares once it registers with the SEC, but it is generally advisable not to commence the offering until comments from the SEC staff are received and appropriately addressed.

   (g) Forms N-1A and N-2 require disclosures relating to a variety of matters, including but not limited to: (i) fund fees and expenses; (ii) investment practices and restrictions; (iii) risks; (iv) management and distribution arrangements; (v) brokerage policies; (vi) taxation; (vii) distribution arrangements and charges; and (viii) financial information. In the case of a publicly offered fund, this information appears either in the fund's prospectus (which is part of the

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registration statement) or in the fund's statement of additional information ("SAI") (which, like the prospectus, is part of the registration statement, but which need be provided to prospective investors only upon request).

(h) A publicly offered closed-end fund must also receive "no objections" clearance from FINRA regarding the reasonableness of the compensation to be received by brokers in connection with the offering, unless the fund is an interval fund that makes periodic repurchase offers pursuant to Rule 23c-3 under the 1940 Act or the fund obtains exemptive relief from FINRA, in which case the sales load limitations of FINRA Rule 2341 (formerly, NASD Conduct Rule 2830) will apply.

(i) A registered fund is required to have "seed capital" of $100,000 prior to commencing a public offering of its shares. (Section 14(a) of the 1940 Act.) The registration statement of a registered fund must include an audited balance sheet reflecting this seed capital.

(j) Open-end funds, as well as closed-end funds that continuously offer their shares, must update financial and other information contained in their registration statements on a periodic basis. Post-effective amendments on Forms N-1A and N-2 are filed annually for this purpose. It may be necessary to supplement a registered fund's prospectus or SAI at other times if there are material events or changes in a fund's features or policies that would, if not disclosed, cause existing disclosures to be misleading.

2. Registering a Definite/Indefinite Number of Securities

(a) Section 24(f) of the 1940 Act and Rule 24f-2 allow an open-end investment company to register an indefinite number of securities under the 1933 Act. If a fund registers an indefinite number of securities, annual filings must be made and the requisite fee paid no later than 90 days after the end of the fund's fiscal year. Registration fees are based on net sales (i.e., redeemed shares are used to offset shares sold for purposes of computing the fee). Interest begins to accrue on the amount of the fee due if the fee is not paid within the 90-day period.

(b) Closed-end funds and BDCs register a specified number of shares under the 1933 Act (generally, the number of shares expected to be sold in the offering to be made pursuant to the registration statement) and pay filing fees in connection with such registration. Only shares that have been registered may be sold, and once all shares registered under a registration statement have been sold, additional shares must be registered.

C. Tax Considerations

1. Taxation Options

(a) 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.

(b) 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.

(c) 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

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sources of its income will preclude RIC qualification, a registered closed-end fund taxable as a partnership may be the only viable option.

(d) 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).

(e) Funds taxed as partnerships are typically organized as limited liability companies or limited partnerships. Funds taxed under Subchapter M are typically organized as statutory trusts, business trusts or corporations.

2. RIC Qualification

(a) 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.

(i) 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.

(ii) 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.

(b) 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.

D. Distribution Arrangements

Shares of registered fund shares may be sold with or without sales charges. Generally, sale charges may be front-end sales loads (paid by an investor at the time shares are purchased), deferred sales loads (paid by an investor in the event redeemed shares have not been held for a specified period) or asset-based sales loads (paid over time as an expense of the fund). (Typically, the amount of a deferred sales load declines each year over a specified period.)

1. Although Section 22(d) of the 1940 Act essentially requires that all investors pay the same sales charges, Rule 22d-1 under the 1940 Act permits open-end funds and their principal underwriters to implement discounts in (or elimination of) sales charges if applied on a uniform basis to all investors of a specified class and disclosed to existing shareholders and prospective investors. This permits the use of quantity discounts, rights of accumulation and other sales charge reductions and waivers.

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FINRA Rule 2341 limits the maximum sales charges that may be imposed by open-end funds and by "interval funds" relying on Rule 23c-3.

2. Many open-end funds issue multiple classes of their shares, each having varying fees and expenses based on differences in the distribution-related expenses and shareholder services of the classes, as permitted by Rule 18f-3 under the 1940 Act. The different share classes are used to address the needs and preferences of different investors and different distribution channels (e.g., investors who prefer a front-end load rather than a deferred sales load, or financial intermediaries that prefer a share class that does not incur any distribution-related expenses — for use by clients participating in advisory programs that pay asset-based fees — and a share class that incurs distribution-related expenses — for use with brokerage clients who pay commissions on their transactions).

3. Continuously offered closed-end funds sometimes issue multiple classes of shares for similar reasons. However, a closed-end fund must obtain an exemptive order from the SEC to do so (because Rule 18f-3 is available only to open-end funds).

4. Open-end funds are prohibited by Rule 12b-1 under the 1940 Act from financing any activity that is primarily related to the distribution of their shares to investors except in accordance with a plan of distribution adopted in accordance with the requirements of the rule. A fund's 12b-1 plan must be approved by the board of directors of the fund, and by vote of a majority of the directors who are not "interested persons" of the fund or its investment adviser ("Independent Directors"). In addition, if the plan is adopted after any public offering of the fund's shares or the sale of shares to any persons other than affiliates of the fund or its promoters, the 12b-1 plan must be approved by fund shareholders. Similar approvals are required to amend a plan to increase materially the amount to be spent for distribution. A 12b-1 plan may remain in effect from year to year if annually approved by the fund's board and by a vote of majority of the Independent Directors.

5. Closed-end funds are not subject to the prohibition of Rule 12b-1. However, closed-end funds that obtain orders to issue multiple share classes are required, as a condition of such orders, to comply with the provisions of Rule 12b-1.

6. In January 2016, the SEC staff issued an IM Guidance Update (No. 2016-01) setting forth its views on issues associated with an open-end fund making payments to financial intermediaries that provide shareholder and account-related services ("sub-accounting" services) with respect to their customers that hold shares of the fund. As noted by the SEC staff, financial intermediaries receiving these payments generally also provide distribution-related services to funds. For this reason, the staff expressed the concern that, in certain circumstances, fees paid by a fund for sub-accounting services may, at least in part, constitute payments for distribution-related services, which would be prohibited unless paid in accordance with a 12b-1 plan. The staff stated that it is the responsibility of the fund's board to determine whether sub-accounting fees (or any portion of such fees) are being used to pay for distribution.

7. Open-end funds and closed-end funds conducting continuous offerings of their shares may enter into selling or underwriting agreements directly with brokerage firms wishing to sell shares of the funds. However, for regulatory and operational reasons, these funds typically retain a distributor to serve as principal underwriter and, in such cases, the distributor enters into selling agreements with intermediaries. Closed-end funds and BDCs making public offerings typically enter into underwriting agreements with brokerage firms. Many fund administrators have affiliated broker-dealers that can serve as distributors and will provide basic distribution services to funds for which they act as administrator. In addition, there are independent marketing firms that can be retained to serve as distributors of a fund. Some of these firms are equipped to serve as "wholesalers" and provide

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access to gatekeepers at brokerage firms and distribution support services that brokerage firms may require.

E. Fund Administration and Compliance

1. Operating registered funds and BDCs requires implementation of policies and procedures to help 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. The rule also requires the appointment of a chief compliance officer ("CCO"). A fund's compliance program and its CCO must be approved by a fund's board and by vote of a majority of its Independent Directors. In addition, the CCO's compensation must be similarly approved.

   (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) A fund's CCO may be removed only by action of the fund's board and by vote of a majority of the Independent Directors.

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

   (e) There is no prohibition on a fund outsourcing the CCO function to a person employed by a firm that is not affiliated with the fund or its adviser. However, the SEC's Office of Compliance Inspections and Examinations ("OCIE") has cautioned that such arrangements should be reviewed to assure that the requirements of SEC rules relating to compliance are being satisfied. (*See* OCIE Risk Alert, "Examinations of Advisers and Funds That Outsource Their Chief Compliance Officers," Nov. 9, 2015.)

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. The services provided by an administrator can include the preparation of financial statements, handling regulatory filings and preparing and distributing materials relating to board meetings (including agendas and drafts of minutes). Services may also include supervision of regulatory and tax compliance.

F. Corporate Governance

1. Composition

   Open-end funds, closed-end funds and BDCs are required to have boards of directors (or, in the case of funds organized as trusts, boards of trustees). A specified percentage of a fund's board must be comprised of Independent Directors. (Section 10(a) of the 1940 Act.)

   (a) As a practical matter (because of the conditions of Rule 0-1 under the 1940 Act that apply to funds that rely on certain 1940 Act exemptive rules), Independent Directors must comprise a majority of a registered fund's board. Section 56 of the 1940 Act requires that a majority of the members of a BDC's board be Independent Directors.

   (b) Generally, persons who are not affiliated with and do not have any direct or indirect beneficial interest in any securities of the fund's investment adviser or principal underwriter (or any of their controlling persons) will not be "interested persons" and will, therefore, qualify as Independent Directors. (Section 2(a)(19) of the 1940 Act.)

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2. Board Responsibilities

(a) Advisory Agreements and Principal Underwriting Agreements: A regulated fund's investment advisory agreement and its agreement with any principal underwriter (i.e., the firm that serves as the distributor of the fund's shares) must be approved by the fund's board and by a majority of the fund's Independent Directors. (Section 15 of the 1940 Act.)

(i) Advisory agreements and principal underwriting agreements may have initial terms of not more than two years from the dates of their execution and may continue in effect from year to year thereafter if such continuance is approved at least annually by a fund's board and by a majority of its Independent Directors. Advisory agreements must be terminable by the fund, without penalty, on not more than 60 days' notice.

(ii) Advisory agreements and principal underwriting agreements must provide for their automatic termination in the event of an "assignment," including a deemed assignment resulting from a change in control of the adviser or principal underwriter.

(iii) In approving and continuing an investment advisory agreement, directors of a fund have a duty to request and evaluate, and the adviser of the fund has a duty to provide, such information as may reasonably be necessary to evaluate the terms of the agreement. (Section 15(c) of the 1940 Act.)

(iv) In addition, Section 36(b) of the 1940 Act provides that the investment adviser of a regulated fund has a fiduciary duty with respect to the receipt of compensation paid by the fund and its shareholders to the adviser (and its affiliates). This has been interpreted in judicial decisions as requiring that an advisory fee be comparable to that which would have been established through arms'-length negotiation.

(v) The SEC has brought enforcement actions against investment advisers and fund directors where the informational requirements of Section 15(c) of the 1940 Act have not (in the view of the SEC) been met. In connection with such actions, the SEC has found that boards were furnished with incomplete information or failed to request sufficient information.[1]

(b) Audit Committee: A regulated fund's board of directors must have an audit committee comprised of Independent Directors. The audit committee is required annually to approve the retention of the fund's independent accountants and to preapprove nonaudit services provided to the fund (and, in certain cases, nonaudit services provided to affiliates of the fund, including the adviser and its affiliates that are deemed part of the investment company complex).

(c) Approval of Accountants: The selection of a fund's independent accountant must also be approved annually by a fund's board and by a majority of its Independent Directors within a specified time frame. (Section 31(a) of the 1940 Act and Rule 32a-3.)

3. Other Board Responsibilities: Fund boards and Independent Directors have a wide range of other responsibilities imposed by rules adopted under the 1940 Act and must approve various other matters relating to a fund's operations.

[1] *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.*

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(a) The board of a fund has general oversight responsibilities with respect to the operations of the fund and the services provided to the fund by its investment adviser and other service providers.[2]

(b) Fund boards typically meet on a quarterly basis. Although participation in such meetings by telephone is generally permissible, Independent Directors must vote "in person" on the approval and continuance of advisory agreements, principal underwriting agreements and 12b-1 plans and on the selection of the fund's independent accountants.

(c) Independent Directors typically are paid annual retainers and per-meeting fees by the fund. In addition, those serving as committee chairs or board chair (or lead independent director) may be paid additional annual retainers.

(d) It is "best practice" that Independent Directors be represented by separate legal counsel. If a fund relies on various exemptive rules, Rule 0-1 under the 1940 Act requires that any such counsel be determined by the Independent Directors initially, and thereafter on an annual basis, to be "independent legal counsel" based on a determination that any representation by such counsel of the fund's investment adviser, principal underwriter or administrator (or any of their control persons) since the beginning of the fund's last two completed fiscal years has been sufficiently limited such that it is unlikely to adversely affect the professional judgment of such counsel in providing representation to the Independent Directors.

4. Shareholder Voting: The 1940 Act and its rules require shareholder voting with respect to certain matters. When a shareholder vote is required, a meeting of shareholders and the solicitation of proxies from shareholders to be voted at the meeting is generally necessary. The solicitation of proxies must be conducted in accordance with the requirements of proxy rules adopted by the SEC under the 1934 Act.

(a) Investment advisory agreements (and material amendments to such agreements) must be approved by a fund's shareholders. (The fund's advisory agreement is typically approved at the time of the fund's formation by written consent of the fund's sole initial shareholder, prior to the sale of shares to investors. Thus, a shareholder vote is generally necessary only to amend an advisory agreement or to approve a new advisory agreement after the fund has commenced operations.) (Section 15(a) of the 1940 Act.)

(b) Directors must be elected by shareholders under certain circumstances, including if: (i) appointment of a new director would result in less than two-thirds of the fund board having been elected by shareholders; or (ii) less than 50 percent of the persons serving as directors have been elected by shareholders. (The initial directors of a fund are generally approved by written consent of the fund's sole initial shareholder at the time of the fund's formation and prior to the sale of shares to investors.) (Section 16 of the 1940 Act.)

(c) Certain investment policies of a registered fund may not be changed without a shareholder vote. This would include, among other things, a change in a fund's policy with respect to concentration of investments, a change in a fund's status from a diversified company to a nondiversified company, a change in policies relating to the borrowing of money or the issuance of senior securities, and any change in other investment policies that have been deemed fundamental by the fund. (Section 13 of the 1940 Act.)

[2] The responsibilities of regulated fund directors include, among other things: monitoring fund investment performance; reviewing fund disclosure documents (and signing registration statements of the fund filed with the SEC); approving agreements with service providers; approving the fund's fidelity bond; reviewing the fund's brokerage commissions and allocation practices; supervising administration of the fund's compliance program; approving valuation procedures; approving the times as of which fund shares are priced; and monitoring the quality and cost of services provided to the fund.

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(d) A shareholder vote is also needed to adopt a 12b-1 plan (if the fund has commenced operations prior to the plan's adoption) and to amend a 12b-1 plan to increase materially the amount to be spent on distribution. (Rule 12b-1 under the 1940 Act, discussed above.)

IV. Key Regulatory Considerations

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) under which asset coverage requirements apply to the issuance of "senior securities". *See* IV.C below.

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 the use of leverage and 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 participating in 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 regulated fund and any of its affiliated persons (including other funds) are purchasing or selling the same securities (or securities of the same issuer). *See* IV.B below.

3. Many BDCs have obtained SEC exemptive orders permitting co-investments with affiliated funds that would otherwise be prohibited pursuant to Section 57(a)(4). *See* IV.E below.

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 nonvoting securities of the underlying fund or contractually waive their voting rights when investing in private funds.

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, subject to certain conditions, 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), or

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having 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 fund serving as general partner or owning 5 percent or more of the interests in the private fund.

6. Section 17(e)(1) of the 1940 Act generally makes it unlawful for any affiliate of a registered fund to accept from any source any compensation for acting as agent in connection with the purchase or sale of any property to or for the registered fund, except in the course of its business as an underwriter or broker.

    (a) Section 17(e)(2) of the 1940 Act and Rule 17e-1 thereunder permit the payment of commissions to an affiliated broker-dealer 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.

    (b) Because of the prohibition of Section 17(e)(1), the adviser of a registered fund (which is deemed to be acting as the fund's agent in placing brokerage orders) may not use the registered fund's brokerage commissions to obtain any service or other benefit other than research services falling within the safe harbor of Section 28(e) of the 1934 Act.

C. 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 funds 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). Section 18(f) of the 1940 Act generally prohibits the issuance of senior securities by open-end funds, but permits such funds to borrow 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 requirement with respect to borrowings and the issuance of senior securities.

4. Under interpretations issued by the SEC and its staff, an investment position of a fund constitutes 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 are not deemed to be senior securities if a fund segregates on its books (or with its custodian bank) liquid assets having a value (marked-to-market daily) at least equal to the amount of its potential obligations.[3]

5. Some registered alternative funds use derivatives to facilitate implementation of investment exposures that they might not otherwise be able to achieve consistent with 1940 Act restrictions.

6. On Dec. 11, 2015, the SEC issued a release proposing to adopt new Rule 18f-4 under the 1940 Act.[4] The proposed rule, if adopted, will regulate the use of derivatives by registered funds and BDCs and

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[3] *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).

[4] *Use of Derivatives by Registered Investment Companies and Business Development Companies,* ICA Rel. No. 31933 (Dec. 11, 2015).

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will also regulate other trading practices of such funds that are deemed to involve the issuance of "senior securities," including short sales of securities. It will also establish overall limits on the use of leverage whether obtained through borrowings, derivatives or other transactions.

(a) The SEC's goal in proposing the rule is 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."

(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. However, it would impose new limitations on the use of derivatives and other practices, and would modify the asset segregation requirements that funds need to meet. If adopted, the provisions of the rule will supersede prior guidance of the SEC and its staff relating to these matters.

D. Trade Allocations

1. Investment advisers have a fiduciary duty to treat all clients fairly. Thus, an advisory firm that manages both traditional mutual funds (or other "long only" accounts), as well as funds or other accounts that pursue alternative investment strategies, needs to assure that its trade allocation policies 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 approach 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 of trades (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). These procedures should also address other trading practices that might be viewed as unfair to any client (e.g., a hedge fund purchasing a thinly traded security shortly after significant sales of the same security by the registered fund).

(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 should be used to monitor compliance with procedures and 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.

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E. 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 participating in any transaction in connection with any "joint enterprise or other joint arrangement or profit-sharing plan" in which the registered fund or the BDC is also a participant absent an order issued by the SEC permitting such transaction.

2. The SEC staff takes 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.[5] However, in a letter to Massachusetts Mutual Insurance Company ("MassMutual"), the staff took a no-action position 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. To facilitate the ability to engage in these transactions, 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.

F. 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 position expressed by the SEC staff in the MassMutual letter. The compliance programs of registered funds of hedge funds should include policies and procedures to address this potential issue.

G. 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.[6]

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 investments be valued at their "fair value," as determined in good faith by the board of directors of a registered fund.

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 by a fund.

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[5] *Massachusetts Mutual Insurance Company* (pub. avail. June 7, 2000).

[6] *See,* e.g., *In the Matter of Morgan Asset Management, Inc., et al.*, ICA Rel. No. 29704 (June 22, 2011); *In the Matter of Calvert Investment Management, Inc.*, ICA Rel. No. 32321 (Oct. 18, 2016).

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5. 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 underlying private funds.

   (a) In its September 2003 report, *Implications of the Growth of Hedge Funds*, 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.

H. New Liquidity Risk Management Rule

1. In October 2016, the SEC adopted Rule 22e-4, which requires mutual funds (other than money market funds) and ETFs that are organized as open-end funds to establish liquidity risk management programs designed to ensure they are able to meet redemption requests without materially affecting remaining investors' interests in the fund. Mutual funds and open-end ETFs must adopt and implement liquidity risk management programs that are reasonably designed to assess, manage and periodically review liquidity risk.[7] The compliance date for new Rule 22e-4 is Dec. 1, 2018 for fund complexes with net assets of $1 billion or more, and June 1, 2019 for fund complexes with less than $1 billion of net assets.

2. Rule 22e-4 also: (i) requires the classification of the liquidity of each of a fund's investments into one of four categories, ranging from highly liquid investments to illiquid investments; (ii) requires a fund to establish a "highly liquid investment minimum" (i.e., the percentage of a fund's assets that will be invested in highly liquid investments), unless the fund invests primarily in highly liquid investments; (iii) prohibits the acquisition of any illiquid investment if more than 15 percent of a fund's net assets would be invested in illiquid investments; and (iv) requires policies and procedures relating to redemptions in-kind (for funds that have the ability to make payment for redemptions by distributing portfolio securities).

3. A fund's board of directors is required, among other things: to approve the fund's liquidity risk management program; to designate a person or persons (which may be the fund's investment adviser, but may not solely be portfolio managers of the fund) to administer the program; to review, at least annually, a written report that addresses the operation of liquidity risk management program and assesses its adequacy and effectiveness; to approve any change in fund's highly liquid investment minimum (if the change is to be made when there is a shortfall in the fund's highly liquid investments); and to oversee the fund's illiquid investments if the 15-percent limit on illiquid investments is exceeded.

4. Funds will be required to include information relating to the liquidity of their investments in reports filed with the SEC on new Forms N-PORT and N-LIQUID.

[7] Unit Investment Trusts ("UITs"), including ETFs organized as UITs, are not subject to the requirement of Rule 22e-4 to establish liquidity risk management programs and are not subject to various related requirements of the rule. However, the rule requires that a UIT's principal underwriter or depositor engage in a limited liquidity review to determine that the portion of the UIT's portfolio comprised of illiquid investments is consistent with the redeemable nature of the securities the UIT issues.

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(a) Monthly reports on Form N-PORT will require a fund to provide information to the SEC on: (i) the liquidity classification of each of its investments; (ii) the aggregate investment liquidity of its portfolio; and (iii) its highly liquid investment minimum. Aggregate portfolio liquidity information will be publicly available (on a delayed basis). However, other liquidity related information will not be publicly available.

(b) A fund must file a report on Form N-LIQUID with the SEC (which will not be publicly available) within one business day if its holdings of illiquid investments exceed 15 percent of its net assets or if its highly liquid investments fall below the fund's highly liquid investment minimum for more than seven consecutive days. If a fund reports that it has exceeded the 15-percent limit on illiquid investments, it is required to make another filing on Form N-LIQUID when the fund's illiquid investments go below the limit.

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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. 15-percent limit on the purchase of Illiquid investments
Key Restrictions on Investments	None	None	Leverage limitation (300-percent asset coverage on debt)	Leverage limitation (300-percent asset coverage on debt)	Leverage limitation (200-percent asset coverage)	Leverage limitation (300-percent 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

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	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 seven- to 10-year term	Periodic repurchase offers (not more frequently than quarterly)	Exchange-traded	Exchange-traded	Daily liquidity at current NAV

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Tax Considerations for 2017

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Noah D. Beck

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 acquisition by Cerberus of the leading automotive supplier ABC Group Inc.; Home Meridian International's sale of its business to Hooker Furniture Corporation; 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" (Practising Law Institute, Corporate Tax Practice Series).

Noah earned an LL.M. and a J.D., *cum laude*, from the New York University School of Law, where he was a Robert McKay Scholar, and a B.A., *cum laude*, from Duke University.

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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 was recently interviewed on the outcome of the Bipartisan Budget Act of 2015 in *Hedge Fund Legal & Compliance Digest*'s article "Impact of New Partnership Tax Audit Rules on Hedge Funds: An Interview with Schulte Tax Partner Philippe Benedict." Philippe also speaks at prominent industry events, including PLI's Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances 2016 conference in New York. He has also 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 and staff member of the *Journal of International Law and Politics*. He obtained his B.S., *summa cum laude*, from Adelphi University.

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Listed in *The Legal 500 United Kingdom* 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.

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Recognized by *The Legal 500 United States* as a leading tax lawyer, David has spoken on tax issues related to running investment management firms and their funds, as well as hedge fund tax considerations and compensation structures. He contributed to "Hedge Fund Employee Compensation," published by *Practical Law*, and *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press). David recently presented "Hedge Funds" at PLI's Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances conference. He is a member of the American Bar Association and the New York State Bar Association.

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Shlomo is co-head of Schulte Roth & Zabel's Tax Group. 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 new partnership audit rules, 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) and writes about topics such as FATCA provisions, FIRPTA and REIT rules, and compliance requirements for hedge funds.

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

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Tax Considerations for 2017

I. Earnings Stripping and Section 385

A. On Oct. 23, 2016, the IRS and the Treasury Department issued final and temporary regulations under Section 385 of the Internal Revenue Code (the "Code"), which made several significant changes to the regulations proposed in April 2016. In general, one set of rules recharacterizes certain debt instruments as equity to the extent issued in connection with certain transactions occurring within an affiliated group. The other set of rules requires issuers to satisfy documentation requirements with respect to certain debt instruments issued within an affiliated group, and failure to do so will, subject to certain exceptions, result in equity characterization.

Although the rules are generally effective for taxable years ending on or after Jan. 19, 2017, the documentation rules are not generally applicable to debt instruments issued before Jan. 1, 2018.

B. Foreign corporate issuers are exempted from the final regulations.

C. Debt of a partnership may still be treated as equity under the rules. Importantly, however, it is treated as equity of the corporate partner in the affiliated group and not the partnership itself.

This is significant in terms of avoiding the potential for publicly traded partnerships. This was a major concern, for example, in the CLO market for pass-through CLOs; however, the "debt for tax" opinions for secured notes issued by CLOs need to take into account these rules.

D. Highly relevant to the fund industry, although the Treasury is continuing to study the issue, the regulations do not apply to leveraged blockers, provided that the owner of the loan is not affiliated with the borrower under the rules. However, issues may still arise with regard to large LPs (e.g., funds of one) or structures with foreign blockers owning U.S. blockers.

E. In light of the congressional and presidential elections, the future relevance of these rules has been put somewhat in question by the possibility of general corporate tax reform, as well as the possibility that the new administration will not enforce these regulations.

II. 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" that are based on a four-factor statutory definition; and

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

2. On Sept. 17, 2015, the 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.

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3. On Dec. 2, 2016, the IRS released Notice 2016-76, which indicates the Treasury's intent to phase in the applicability of the 2015 Regulations differently for transactions entered into each of: (i) calendar year 2017; and (ii) calendar year 2018 and subsequent calendar years.

B. Statutory Provision

1. Under Section 871(m) of the Code, 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. Section 871(m) of the Code authorizes the Treasury to specify other transactions as being "Specified NPCs" or otherwise substantially similar to a transaction yielding a dividend equivalent payment. The 2015 Regulations, as modified by IRS Notice 2016-76, expand the universe of transactions subject to Section 871(m) of the Code, if such transactions are entered into (or significantly modified) after 2016 or 2017, as applicable.

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 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.

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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 one (completely dependent on the value of the underlying security) to zero (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

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ELI or a specified NPC, as applicable. The 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. Time of Withholding

   Withholding is required at the later of:

   (a) The time the amount of the dividend equivalent is determined, which is the later of: (i) the day prior to the ex-dividend date; and (ii) the record date; and

   (b) The time a payment occurs. A payment is deemed to occur:

       (i) If money or other property is paid to the long party, which includes the economic benefit to the long party of netted payments within the contract that would otherwise have been made at such time; or

       (ii) The long party sells or disposes of the contract, including by virtue of termination of the contract, lapse of the contract, offsets or otherwise.

6. 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.

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(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.

This affects swaps on "master limited partnerships." Fund managers should have upfront communications with their brokers to understand how they intend to apply these set of rules, including whether they may be over-withholding on a swap if they cannot get sufficient comfort that the particular master limited partnership referenced under the swap is not a covered partnership.

(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 (i.e., the exception does not apply to over-the-counter transactions); or (iii) targets dividends. Entering into a short position that references component security of a qualified index may invalidate a qualified index Section 871(m) transaction. There is a "de minimis" safe harbor for a short position that reduces the exposure to referenced components securities of a qualified index by five percent or less of the value of the long positions in component securities in the qualified index.

(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).

D. Notice 2016-76

1. Transactions Entered Into During Calendar Year 2017

(a) "Delta One" Transactions

(i) The term "delta one" was not defined in the notice. However, the language of the notice supports that only simple contracts can be "delta one" transactions.

(ii) A transaction is a Section 871(m) Transaction if it has a delta of 1.0 on the date of issuance.

(b) Combined transactions (as described above) that have a delta of 1.0 are within the scope of the Notice. However, a broker acting as a short party will only need to combine over-the-

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counter transactions that are priced, marketed or sold in connection with each other. Long parties would still be responsible for the substantive tax for transactions that are combined under the 2015 Regulations, even if the short party is not responsible for withholding any tax.

(c) The IRS will apply a good faith standard to determine whether long and/or short parties applied the combination, withholding and other rules during 2017.

(d) Non-U.S. long parties who are registering with the IRS to act as "qualified derivatives dealers" ("QDDs") can attest to that status on a W-8IMY if they apply for QDD status by March 31, 2017. Short parties can rely on such statement as a basis not to withhold on dividend equivalent payments made to such a counterparty until they are notified that the QDD designation is not valid.

2. Transactions Entered Into After 2017

(a) All other transactions entered into after 2017 (or significantly modified after 2017) that are considered Section 871(m) Transactions under the 2015 Regulations will be subject to the withholding and substantive tax provisions.

(b) The IRS will apply a good faith standard for actions taken by taxpayers during 2018 for Section 871(m) transactions entered into during 2018 that are not "delta one" transactions, including whether taxpayers are properly applying the "substantial equivalence" test.

III. Planning for Payment of Deferred Fees in 2017

A. Section 409A Considerations

1. Pre-2009 fees that have been deferred by managers using the cash method of tax accounting (i.e., almost all such deferred fees) are still subject to Section 409A of the Code, even though Section 457A of the Code generally requires managers to include such amounts in the managers' taxable income no later than 2017.

2. Failure to comply with Section 409A of the Code can lead to an additional tax equal to 20 percent of the entire amount deferred, as well as additional interest on the amount deferred going back to the tax return due date for the initial year of deferral.

3. Any deferred fee agreements that are part of a "back-to-back" arrangement need to be operated such that both the payment by the fund to the manager and the related distribution or payment by the manager to its partners and employees comply with Section 409A of the Code.

4. Payment is not considered late under Section 409A of the Code if it is paid by the end of the calendar year in which the elected distribution date occurs.

B. Size of Deferral/Portfolio Management

1. If the deferred fees represent a significant portion of the fund's gross assets, the manager may want to consider exploring with the fund ways to gradually change how the deferred fees are indexed.

2. If a fund is in liquidation, the manager generally cannot receive accelerated payment of its deferred fees until the termination of the manager's services to the fund (e.g., if the liquidation were complete). The manager may desire to elect, with the fund's consent, to have the portion of its

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deferred fees that would otherwise have been paid to it had the manager been a shareholder of the fund indexed to treasury bills as and when shareholders are paid.

C. Payment In Kind

1. As deferred fees must generally be paid out when due, a payment in kind may be a desirable approach for a fund where the manager either does not wish to liquidate substantial assets or is not able to monetize particular positions (e.g., side pockets) to pay the deferred fees out in cash.

2. If payment is made in the form of shares of the fund from which the deferral election was made, the manager should consider whether a "qualified electing fund" election is available and, if so, desirable.

3. If the fund is part of a mini-master or master-feeder structure, payment may be made in the form of a master fund interest. Managers who are in this situation may want to consider whether it would be feasible to make an election under Section 754 of the Code at the master fund level, which would avoid the manager's picking up additional tax in that situation.

4. Managers need to note that they will still be subject to full U.S. federal, state and local income tax on the value of the in-kind assets paid to them and should consider their cash needs in relation thereto.

D. Investor Relations

1. Managers should be prepared to answer investor inquiries regarding what they plan to do with the after-tax portion of the deferred fees they are paid.

2. For managers who had treated their deferred compensation as a way of aligning their interests in the fund with those of their investors, payment in kind of at least a portion of the deferred fees may be desirable.

IV. United Kingdom: Changes to the Taxation of Carried Interest

On April 6, 2016, the United Kingdom's new rules on "income-based carried interest" (IBCI) became effective. The IBCI rules are the final piece of a comprehensive new regime for the taxation of sums arising to investment managers from their provision of investment management services in the United Kingdom. This regime is made up of the "disguised management fees" (DMF) rules — of which the IBCI rules are a subset — and the rules on "performance-related returns," i.e., carried interest that is not IBCI.

In relation to carried interest in the usual form of partnership allocations, the most radical departure under the new regime is that there is no look-through to the particular items of income or gain which make up the carried interest, with the investment manager taxed according to the character of those underlying items. Rather, an allocation of carried interest received by an investment manager is treated as a separate sum arising to the investment manager (whether this is comprised of underlying income, realized gains or unrealized gains), which is taxed under the new regime according to where the manager has performed the investment management services that give rise to his carried interest.

In summary, where carried interest is not IBCI, the investment manager is chargeable to U.K. capital gains tax (CGT) at a special carried interest CGT rate of 28 percent. Where, however, the carried interest is IBCI, the investment manager is chargeable to tax on his carried interest as if he had received a disguised management fee for purposes of the DMF rules. Disguised management fees are taxed as the profits of a notional trade carried on by the investment manager, and so are subject to 45-percent income tax and 2-

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percent national insurance contributions. The determination of whether a carried interest is or is not IBCI is therefore of crucial importance.

A. Income-Based Carried Interest

1. The income-based carried interest rules require an investment manager to calculate, on each occasion, when a sum of carried interest arises to him, the average value-weighted holding period of all the assets ever held by the fund from which the carried interest is derived, as at the date upon which the carried interest arises. If that period is 40 months or more, none of the carried interest is IBCI and the sum arising is taxed entirely under the CGT carried interest regime, at 28 percent. If the period is less than 36 months, all of the carried interest is IBCI and is taxed as a disguised management fee at an effective rate of 47 percent. There is a taper where the period is between 36 months and 40 months, with an increasing proportion of the carried interest being taxed under the CGT carried interest regime (28 percent) for each additional month of average value-weighted holding period between 36 months and 40 months.

2. There are some complex provisions in the IBCI rules dealing with how managers should calculate the average value-weighted holding period for which a fund has held its assets, in particular, in the areas of derivatives, hedging and foreign exchange gains and losses, direct lending and position-building. There is also provision for carried interest arising in the first four years of a fund's life to be treated as "conditionally exempt," so that such sums arising can be treated as not IBCI if the 40 months or more average value-weighted holding period test is met at the expiry of that initial four-year period, even if the test is not met as at the date on which the carried interest arises.

B. Territorial Scope

1. The fact that investment managers are now chargeable to U.K. tax on carried interest according to where they perform the investment management services that give rise to the carried interest has led to a substantial increase in taxation for some U.K. investment managers. In particular, those U.K. investment managers who are not domiciled for tax purposes in the United Kingdom were previously able to claim the remittance basis of taxation — and defer any U.K. tax charge — to the extent that their carried interest was made up of non-U.K. source income or non-U.K. source capital gains. Under the new regime, any carried interest is subject to U.K. tax if the investment management services that give rise to it are performed in the United Kingdom, with no account being taken of the domicile status of the investment manager or income and gains of which the carried interest is made up. This change in the territorial basis of the tax charge, combined with the application of the IBCI rules where a fund does not meet the 40 months or more average holding period test, will mean that some non-U.K. domiciled investment managers who were previously not liable to tax on their carried interest will now be liable to tax at 47 percent.

2. When the DMF and IBCI rules were first published, there were some initial concerns that the fact that IBCI is charged to U.K. tax on the basis of whether investment management services are performed in the United Kingdom might cause U.S. or other non-U.K. resident investment managers receiving carried interest to become liable to U.K. tax even if they spend only short amounts of time in the United Kingdom. However, HMRC guidance has confirmed that because the new rules tax IBCI as the profits of a notional trade carried on by the investment manager, applicable double tax treaties will mean that most such managers will only be liable to U.K. tax if they could be regarded as carrying on that notional trade in the United Kingdom through a U.K. permanent establishment. Since it is unlikely that individuals spending short amounts of time in the United Kingdom would have a U.K. permanent establishment (a permanent establishment of their own, not of the business for which they work), it seems that this should not be an issue in practice.

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C. Tax Credits

The new rules have the effect of shifting the point at which investment managers become liable to U.K. tax on carried interest to the time at which an amount of carried interest arises to the investment manager, rather than the time of realization of portfolio assets. Where carried interest is calculated by reference to unrealised gains, this means that the U.K. tax charge could precede the realization of the asset by a substantial period. Where an investment manager is subject to tax in more than one jurisdiction (for example, a U.S. citizen living and working in the United Kingdom), this raises some difficult issues as to how the manager can claim and match tax credits on carried interest if the bases of taxation are different. If, for example, the U.K. taxes by reference to the point at which the carried interest sum arises to the investment manager, but the United States continues to tax by reference to the investment manager's allocation of gain arising on realisation of the underlying portfolio asset, it is not clear that the U.K. tax paid on the carried interest will automatically be creditable against U.S. tax determined on a different basis. Further guidance is awaited from HMRC on the IBCI rules and it is to be hoped that at least some consideration will be given to these difficult international issues.

V. Amendments to Cayman Islands Common Reporting Standard ("CRS")

A. Amendments to the Cayman Islands CRS Regulations were released in mid-December 2016 as part of the Cayman Islands' implementation of CRS.

The amendments address CRS compliance and enforcement in the Cayman Islands.

B. Key Provisions of the Amendments

1. Financial Institutions ("FIs") need to maintain written policies and procedures on CRS compliance.

2. Notification/Registration Requirement for Reporting and Non-reporting Financial Institutions

All Cayman Islands Financial Institutions — both reporting and nonreporting — must file an "information notice," as well as a change notice when changes occur.

The notice must include:

(a) Institution name and number from the Cayman Islands Tax Information Authority (the "TIA");

(b) Whether the FI is reporting or nonreporting; and

(c) The specific type of reporting or non-reporting FI, as applicable (e.g., "investment entity").

3. Annual Reporting: Cayman Islands FIs with no reportable accounts for the year must file a nil return.

4. What is considered an offense?

(a) Investors

(i) An offense is committed if a person makes a false self-certification and gives it to a Cayman Islands FI.

(ii) It does not matter that:

(1) The self-certification was made outside of the Cayman Islands;

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(2) The person did not know or have reason to know the self-certification was false; or

(3) Someone else gave the FI the self-certification.

(b) Cayman Islands FIs

An offense is committed if a Cayman Islands FI discovers but does not report inaccurate information to the TIA "as soon as practicable."

(c) A reasonable excuse defense is available, but reliance on a service provider is not a reasonable excuse.

(d) Liability of Individuals in Charge of Cayman Islands FIs

(i) The individuals in charge of a Cayman Islands FI that commits an offense are also guilty of that offense.

(ii) Proof that the individual exercised reasonable due diligence is a defense.

5. Penalties for Offenses

(a) The "primary penalty" for an offense is $50,000 for entities or $20,000 for individuals.

(b) A further penalty of $100 per day may be imposed if the contravention has not been remedied and the party is capable of remedying it.

6. Statute of Limitations: The statute of limitations for imposing penalties is typically one year after the TIA learns of the contravention or six years after the contravention occurs.

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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 was recently interviewed on the outcome of the Bipartisan Budget Act of 2015 in *Hedge Fund Legal & Compliance Digest*'s article "Impact of New Partnership Tax Audit Rules on Hedge Funds: An Interview with Schulte Tax Partner Philippe Benedict." Philippe also speaks at prominent industry events, including PLI's Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances 2016 conference in New York. He has also 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 and staff member of the *Journal of International Law and Politics*. He obtained his B.S., *summa cum laude*, from Adelphi University.

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Hedge Funds
Private Equity

Stephanie R. Breslow

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 (including LBO, mezzanine, distressed, real estate and venture) and liquid-securities funds (including hedge funds and hybrid funds), as well as providing regulatory advice to investment managers. 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 serving as 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 former member of the board of directors and current member of 100 Women in Finance, 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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Practices

Employment & Employee Benefits

Private Equity

Regulatory & Compliance

Trading Agreements

David M. Cohen

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).

In recognition of his accomplishments, David has been selected for inclusion in *Chambers USA*, *The Best Lawyers in America* and *New York Super Lawyers*. He has spoken and written widely on ERISA and benefit fund-related issues, including authoring ERISA compliance guides for broker-dealers for Practising Law Institute and presenting on "Fund Formation Issues," "Current Topics in Private Equity and Alternative Investments" and "Current Fiduciary Issues" for recent PLI Pension Plan Investments conferences. He is also a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press).

David earned his J.D. from The George Washington University Law School and his B.A. from Columbia University.

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Practices

Investment Management
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Hedge Funds
Energy
Cybersecurity

Brian T. Daly

Brian advises hedge, private equity and real estate fund managers on regulatory, compliance and operational matters. He has extensive experience designing and improving compliance processes and organizational systems and helps clients navigate their initial and ongoing regulatory compliance obligations under the rules and regulations of the Securities and Exchange Commission, the Commodity Futures Trading Commission, and the National Futures Association. Brian also regularly represents clients in enforcement actions, regulatory examinations, trading inquiries, and in seeking no-action or similar relief. Having spent nearly a decade in-house as general counsel and chief compliance officer of several prominent investment management firms, Brian is well-versed in the wide range of legal and business challenges facing investment advisers, commodity pool operators and commodity trading advisers.

Brian is a recognized leader in advising alternative investment fund managers on regulatory and compliance matters and is well-known for his thought leadership in this area. He also regularly represents managers in examinations, investigations, and enforcement actions in both the securities and the commodity futures sectors. *Chambers Global* and *Chambers USA* list Brian as a "leading individual" in investment funds, noting that he is "especially skilled at assisting clients with the development of strategic compliance programs." Interviewees also praise him for knowing "what it's like on the ground" and for providing "practical and meaningful advice." In addition to hosting SRZ webinars, participating in firm-sponsored seminars and workshops, and authoring *SRZ Client Alerts* and *SRZ White Papers*, he authored "New Form ADV: The Impact on Private Fund Advisers" and "The New FINRA Registration Requirement for Algorithmic Traders: Implications for Broker-Dealers and Investment Advisers," published in *The Hedge Fund Journal*. His recent speaking engagements addressed topics including current trends and challenges in systematic and quant strategies, and managing attorney-client privilege. 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, as well as 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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Managing Principal
CarVal Investors

Lucas Detor

Lucas is a managing principal and member of the executive team and investment committee for CarVal Investors and responsible for leading the firm's investment strategy and management. He also leads the firm's high-yield and transportation investments, and oversees capital formation and emerging markets for the firm. Lucas joined CarVal from Morgan Stanley, where he most recently served as managing director and co-head of the global distressed and U.S. leveraged loan business. Lucas has also served the U.S. government as a special agent with the U.S. Secret Service, as well as in the U.S. Army Reserve and New York National Guard.

CarVal Investors is a leading global alternative investment fund manager focused on distressed and credit-intensive assets and market inefficiencies. Since 1987, our experienced team has navigated through ever-changing credit market cycles, opportunistically investing $90 billion in 5,300 transactions across 76 countries. Today, CarVal Investors has approximately $10 billion in assets under management in both credit and real estate strategies.

Lucas received his MBA from NYU Stern School of Business and his B.S. in accounting from SUNY Albany. He is a Certified Public Accountant (inactive).

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Practices

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Hedge Funds
Private Equity

Jennifer Dunn

Jennifer 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 laws 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.

A member of the board of directors of 100 Women in Finance, Jennifer is 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 has been named an *IFLR1000* "Rising Star" (Investment Funds). She co-authored *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and recently presented at conferences on topics including operational due diligence, compliance issues, hedge funds and management company structures, and considerations for emerging hedge fund managers.

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

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Practices

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David J. Efron

David practices 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 Global* and *Chambers USA* have 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 that "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 praised his "superb judgement and deep expertise" and recognized him as "an extraordinarily capable attorney. He has a mastery of the pertinent matters, but he also brings a pragmatic approach." A published author on subjects relating to investment management, David recently contributed to "Hedge Fund Employee Compensation," published in *Practical Law*, and co-authored *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press). He is also a sought-after speaker for hedge fund industry conferences and seminars, as well as 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.

David received his B.A. from Vassar College, his J.D. from Syracuse University College of Law and an LL.M. degree in securities regulation, *with distinction*, from Georgetown University Law Center.

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Practices

Regulatory & Compliance
Cybersecurity
Energy
Hedge Funds
Investment Management
Litigation

Marc E. Elovitz

Marc is the chair of Schulte Roth & Zabel's Investment Management Regulatory & Compliance Group. He advises hedge funds, private equity funds and funds of funds 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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Practices

Business Reorganization

Bankruptcy & Creditors' Rights Litigation

Distressed Investing

Energy

David M. Hillman

David practices in the areas of corporate restructuring and creditors' rights litigation, with an emphasis on the representation of secured and unsecured creditors and other parties in Chapter 11 bankruptcy cases. He has recently represented the creditors' committee in Maxus Energy Corp., and Cerberus Capital Partners LP as a secured creditor in connection with the Chapter 11 case of RadioShack Corp., and he is currently representing an ad hoc group of equity holders in Republic Airways Holdings Inc. and first lien noteholders and DIP lenders in the Chapter 11 case of Allied Systems Holdings in connection with intra-lender equitable subordination litigation. David has significant experience litigating issues involving solvency, valuation, plan confirmation, financing and cash collateral disputes, contested 363 sales, fraudulent transfers, preferences, equitable subordination, recharacterization, substantive consolidation, breach of fiduciary duty and similar disputes.

David is listed as a "leading individual" in bankruptcy/restructuring by *Chambers USA*, which noted that interviewees praised him as "wonderful to deal with," "very effective" and an "excellent litigator and strategist" who "thinks outside the box." *Chambers* also noted that David is "an excellent counselor for distressed situations with significant litigation elements" and "a terrific, conscientious and focused lawyer." He has also been recognized as a leader in his field by *New York Super Lawyers*. A member of the American Bankruptcy Institute, David speaks frequently on bankruptcy-related topics including recent decisions affecting secured creditor rights and preparing creditors for bankruptcy risks. He recently co-authored "Seventh Circuit Limits Bankruptcy Safe Harbor Protection," published in *Westlaw Journal – Bankruptcy* and his articles have appeared in other publications such as Practising Law Institute's *28th Annual Current Developments in Bankruptcy & Reorganization*, *Aspen Law & Business' Bankruptcy Litigation Manual*, *Pratt's Journal of Bankruptcy Law*, *Reorg Research*, *Law360*, *The Bankruptcy Strategist*, *Bankruptcy Court Decisions* and *NYU Journal of Law and Business*.

David received his J.D., *cum laude*, from Albany Law School, where he was associate editor of the *Albany Law Review*, and his B.A., *cum laude*, from New York State University at Oneonta.

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Practices

Investment Management
Hedge Funds
Private Equity
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Daniel F. Hunter

Dan concentrates his practice on the design, structure and regulation of private investment funds, including hedge funds, hybrid funds and private equity funds. He specializes in providing advice to credit funds and advises on insurance dedicated funds. 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 recently presented an SRZ webinar on "Insurance-Dedicated Funds: Tax and Corporate Issues," and at an SRZ breakfast briefing on "Current Issues Impacting Private Investment Funds." He also spoke at the AIMA Navigating the Landscape of Side Letter Terms Seminar. Dan was recently featured in *The Hedge Fund Journal* article "Co-Investments with SRZ's Leading Fund Formation Group" and is a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press). 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

Investment Management
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Regulatory & Compliance

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 "Information Security: Obligations and Expectations," an *SRZ White Paper*. He recently spoke at the Goldman Sachs Nineteenth Annual Hedge Fund Conference and 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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Practices

Shareholder Activism
Mergers & Acquisitions
PIPEs
Regulatory & Compliance
Private Equity
Securities & Capital Markets
Distressed Investing
Energy

Eleazer Klein

Ele practices in the areas of shareholder activism, mergers and acquisitions, securities law, 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 is also 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/Reg SHO, 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* 2016 (SRZ in association with Activist Insight and FTI Consulting) 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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Practices

Investment Management
Hedge Funds
Regulated Funds
Regulatory & Compliance

John J. Mahon

John 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 ranging from SEC regulations and disclosure obligations to public and private capital raising structures, 1940 Act regulated funds and M&A issues. Recently, John addressed what alternative investment managers need to know about managing 1940 Act regulated funds at an SRZ webinar.

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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Practices

Investment Management

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Hedge Funds

Regulatory & Compliance

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 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 managers on several key pieces of recent EU legislation (including the Short Selling Regulation, Alternative Investment Fund Managers Directive, MiFID II, MAR, EMIR and SFT Regulation). 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 United Kingdom 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 authored the "Insider Trading Law in the United Kingdom" chapter in *Insider Trading Law and Compliance Answer Book* (Practising Law Institute) and co-authored "Brexit: What Alternative Asset Managers Can Expect," published in *The Hedge Fund Journal*. Her recent speaking engagements have addressed topics including market abuse and insider dealing, 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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Practices

Finance

Distressed Investing

Michael M. Mezzacappa

Michael focuses on representing agents, lenders and borrowers in a variety of complex financings and credit arrangements, acquisition financings (including sponsor-led and strategic acquisitions and "going private" transactions), dividend recapitalization financings, asset-based loans, cash flow loans, special situations loans, DIP loans, bridge financings and cross-border and multi-currency loans. He has extensive experience representing agents and lenders in multi-tiered financing facilities, second-lien and unitranche loan facilities (including "B" loans and other "last out" structures), mezzanine and subordinated debt facilities, distressed debt facilities and intercreditor and subordination agreements. Michael also advises on distressed investing, debt restructuring and workouts as part of Schulte Roth & Zabel's Distressed Investment Group.

Michael is a member of the American Bar Association's Business Law Section, the New York City Bar Association, the Commercial Finance Association and the Turnaround Management Association. He is often invited to share his expertise at financial industry events, giving presentations on out-of-court restructurings of distressed debt and post-credit crunch deal terms.

Michael obtained his J.D., *magna cum laude*, from New York Law School, where he served on the *New York Law School Review*, and his B.S, *with honors*, from City University of New York.

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Practices

Investment Management
Hedge Funds
Private Equity
Energy
Financial Institutions

David Nissenbaum

David is a partner in Schulte Roth & Zabel's Investment Management Group. 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 advises on fund structuring, fundraising, management company partnerships, compensation plans, succession plans, seed and strategic investments and spinoffs of investment teams. His work 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. Clients often seek his advice on business matters and strategy as well.

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 past member of the Advisory Board of The Financial Executives Alliance and 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*, published by ALM Law Journal Press; "Just Like Starting Over: A Blueprint for the New Wall Street Firm," published by *The Deal*; and "Hedge Fund Manager Succession Planning" and "Federal Reserve Provides Greater Flexibility for Non-Controlling Investment in Banks and Bank Holding Companies," published by SRZ. 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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Practices

Broker-Dealer Regulatory & Enforcement

Hedge Funds

Investment Management

Regulatory & Compliance

Julian Rainero

Julian is co-chair of Schulte Roth & Zabel's Broker-Dealer Regulatory & Enforcement Group. He advises broker-dealers and alternative trading systems on compliance with SEC, self-regulatory organization (SRO) and Federal Reserve Board rules. His practice involves all aspects of broker-dealer regulation, with a focus on cash equities trading practices, alternative trading systems, net capital, customer asset segregation, prime brokerage, correspondent clearing, and margin and securities lending. Julian represents many of the leading electronic market makers and alternative trading systems and serves on the best-execution committees of several major broker-dealers. In addition to regularly advising broker-dealers on regulatory compliance and best practices, Julian represents clients in responses to examination findings and enforcement proceedings. He also provides legal counsel to financial institutions in connection with acquisitions of or investments in broker-dealers, credit facilities collateralized by securities and transactions subject to Regulation M.

Recognized by *Chambers USA* and *The Legal 500 United States* as a leading financial services regulatory lawyer, Julian recently co-authored "The New FINRA Registration Requirement for Algorithmic Traders: Implications for Broker-Dealers and Investment Advisers" and was featured in "Execution Enforcement Actions Escalate," both of which were published in *The Hedge Fund Journal*.

Julian earned his J.D. from American University Washington College of Law and his B.A. from Dickinson College.

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Practices

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Private Equity
Regulatory & Compliance
Securities & Capital Markets

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 senior director of the Legal Defense Fund of the NAACP and a member of 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.

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President and CEO
DuPont Capital Management

Valerie J. Sill, CFA, CAIA

Valerie is president and CEO of DuPont Capital Management (DCM) and serves as its chief investment officer. She is responsible for overseeing the investment of more than $25 billion in assets held by DuPont Company plans and external clients. DCM manages assets across nine different asset classes using a value-based investment approach that combines valuation and risk control disciplines designed to produce risk-efficient excess returns that satisfy its clients' investment objectives. Prior to joining DCM in April 2004, Valerie was executive vice president at The Boston Company. There, she chaired the Equity Policy Group and was the director of Large Cap Value strategies. She was a dual officer with Dreyfus, also a Mellon company, where she managed the Dreyfus Premier Core Value mutual funds. In addition to her work at The Boston Company and Dreyfus, Valerie formed and chaired Mellon's Research Forum to foster collaboration among investment professionals from each of Mellon's investment management subsidiaries.

Valerie started her career in asset management with State Street Research & Management Company as a Health Care and Utilities analyst and later joined Investment Advisors in Minneapolis as a senior analyst.

Valerie is a member of the Board of Trustees of Longwood Gardens and chairs its Investment Committee. Valerie is a trustee of the Christiana Care Health System and chairs its Investment Committee. She is also a member of the Delaware Community Foundation's Investment Committee. Valerie served a three-year term on the Federal Reserve Bank of Philadelphia's Economic Advisory Council. Valerie was awarded a B.A., *magna cum laude*, in economics and philosophy from Wellesley College, where she was elected to Phi Beta Kappa and was a Durant Scholar. She holds an MBA from Harvard University and was awarded both the CFA and CAIA charters.

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Investment Management

Hedge Funds

Private Equity

Real Estate Capital Markets & REITs

Energy

Joseph A. Smith

Joe represents private equity fund sponsors and institutional investors in connection with fund formation, the acquisition of portfolio investments and the implementation of exit strategies. In this capacity, Joe advises clients on securities, governance, ERISA, Investment Advisers Act and structural issues. He has extensive experience with all alternative asset classes, including venture capital and later-stage growth equity investments, leveraged buyouts, mezzanine investments, real estate ventures and opportunity funds, secondary investments, funds of funds and hedge funds. Joe has also represented many fund managers in connection with spinoffs and consolidations. In addition to domestic representations, Joe has advised private equity clients in connection with the acquisition and structuring of portfolio company investments throughout Europe, Latin America and Asia. His representation of asset managers in the real estate sector includes advice concerning REIT offerings and privatizations, partnership roll-ups and cross-border investments. Joe's clients include Arcis Group, Coller Capital, DRA Advisors, DuPont Capital Management, GE Asset Management (now State Street Global Advisors), Harbert Management Corporation, Hemisfério Sul Investimentos, Intel, Kotak Mahindra Group, LCN Capital Partners, The Praedium Group, Ram Realty Services, REAL Infrastructure Partners, Royalton Partners, Top Tier Capital Partners, Value4Capital, VCFA Group and Westport Capital Partners.

Recently featured in *Private Fund Management*'s "Ringing the Changes" article, Joe has been recognized as a leading practitioner by *Chambers Global*, *Chambers USA, Expert Guide to the World's Leading Banking*, *Finance and Transactional Law Lawyers*, *The Legal 500 United States* and *New York Super Lawyers*. Joe is a sought-after speaker for private equity industry conferences and is the author of many articles on industry trends and developments. He co-authored the "United States Fundraising" chapter in *The Private Equity Review* (Law Business Research Ltd.) and recently presented "Current Terms: Private Equity Funds" at IBA's 17th Annual International Conference on Private Investment Funds.

Joe received his A.B. from Columbia University and his J.D. from New York University School of Law.

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Practices

Structured Finance & Derivatives

Regulatory & Compliance

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Craig Stein

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" and "very thoughtful about the market." *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 authored "U.S. CLOs: Past and Present," published in *The Journal of Structured Finance*, and is co-author of "CLOs and Risk Retention in the U.S. and EU: Complying with the Rules," published in *The International Comparative Legal Guide to: Securitisation 2016.* He spoke on how alternative asset managers and banks work together post-Basel III and on the latest trading-related compliance and enforcement concerns.

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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Practices

Litigation

Complex Commercial Litigation

Securities Enforcement

Securities Litigation

Shareholder Activism

Michael E. Swartz

Michael focuses his practice on complex commercial, securities and business litigation, as well as antitrust, particularly as it relates to mergers and acquisitions. Michael's litigation practice includes securities class actions, M&A litigation, shareholder activist litigation, proxy contests and other corporate-control disputes. He has particular experience with matters involving Sections 10, 13, 14, 16 and 20 of the Securities Exchange Act and Sections 11, 12 and 15 of the Securities Act. Michael's recent litigation experience includes activist litigation for Villere & Co. and Land & Buildings, as well as representations of several boards and companies in M&A- and proxy-related litigation. He represents several funds in Section 16(b) litigation, and recently obtained a dismissal of one such action based on the registered investment adviser exemption. Michael represented a U.K. hedge fund, The Children's Investment Fund, in a trial involving proxy litigation against CSX Corp. and served as trial counsel to a former chief legal officer of media giant Hollinger International Inc. in a four-month criminal trial. He also represented Cerberus Capital Management in their $9-billion acquisition of Safeway Inc. and served as trial counsel to the former Vivendi Universal CFO in a four-month securities class action jury trial brought by a class of French shareholders and holders of American depository shares. The jury returned a verdict of no liability for SRZ's client for securities fraud.

Michael has been recognized by his peers and clients in *Benchmark Litigation: The Definitive Guide to America's Leading Litigation Firms and Attorneys*, *The Legal 500 United States* and *New York Super Lawyers* in the area of business litigation. A frequent speaker and author, he co-authors the "Information Sharing with Market Professionals" chapter in the *Insider Trading Law and Compliance Answer Book* (Practising Law Institute) and recently co-authored "Activism and Passivity: HSR Act and Section 13(d) Developments for Investors," published in both *Westlaw Journal – Securities Litigation & Regulation* and *The Hedge Fund Journal*. His recent speaking topics have addressed developments in shareholder activism, how to navigate risks associated with M&A deals and changing investor-manager relationships. A former law clerk to the Hon. Irving R. Kaufman, Circuit Judge for the U.S. Court of Appeals for the Second Circuit, Michael is currently the regional vice chair for the Mid-Atlantic Region of the Lawyers' Committee for Civil Rights Under Law. He is also a member of the ABA's Litigation and Antitrust sections.

Michael obtained his J.D. from Columbia Law School, where he was editor of the *Columbia Law Review*, and his B.A., *magna cum laude*, from the University of California, Los Angeles, where he was elected to Phi Beta Kappa.

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Regulated Funds

Shlomo C. Twerski

Shlomo is co-head of Schulte Roth & Zabel's Tax Group. 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 new partnership audit rules, 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) and writes about topics such as FATCA provisions, FIRPTA and REIT rules, and compliance requirements for hedge funds.

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

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Practices

- Broker-Dealer Regulatory & Enforcement
- Hedge Funds
- Investment Management
- Regulatory & Compliance
- Securities Enforcement
- White Collar Defense & Government Investigations

Craig S. Warkol

Craig is co-chair of Schulte Roth & Zabel's Broker-Dealer Regulatory & Enforcement Group. His practice focuses on securities enforcement and regulatory matters for broker-dealers, private funds, financial institutions, companies and individuals. Drawing on his experience both as a former enforcement attorney with the U.S. Securities and Exchange Commission and as a Special Assistant U.S. Attorney, Craig represents clients before the SEC, DOJ, FINRA and other self-regulatory organizations and state regulators. Craig also advises corporate officers, boards, audit committees, investment advisers and broker-dealers regarding the federal securities laws and, when necessary, defends them in connection with enforcement proceedings. Craig also has experience representing entities and individuals under investigation for, or charged with, securities fraud, mail/wire fraud, accounting fraud, insider trading, market manipulation, money laundering, Foreign Corrupt Practices Act (FCPA) violations and tax offenses. In his previous role as a Special Assistant U.S. Attorney for the Eastern District of New York in the Business and Securities Fraud section, he prosecuted allegations of securities fraud, insider trading, mail and wire fraud, money laundering and tax offenses. Craig also previously served as senior counsel in the enforcement division of the SEC, where he investigated and prosecuted numerous violations of federal securities laws, including insider trading, accounting fraud, offering fraud, Ponzi schemes and broker-dealer improprieties.

Recognized as a leading litigation lawyer in *Benchmark Litigation: The Definitive Guide to America's Leading Litigation Firms and Attorneys*, *The Legal 500 United States* and *New York Super Lawyers*, Craig started his career as an associate in the business and securities litigation section at a New York-based Am Law 100 firm and has also served as a law clerk to the Honorable Lawrence M. McKenna of the U.S. District Court for the Southern District of New York. He has written about enforcement actions against hedge funds and other industry-related topics, and has spoken on attorney-client privilege.

He received his J.D., *cum laude*, from Benjamin N. Cardozo School of Law and his B.A. from the University of Michigan.

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Tax Outlook

I. Current Prospects for Carried Interest Legislation

A. There have been numerous proposals to change the taxation of investment managers' carried interest.

B. In past years, Republican members of Congress have successfully defeated attempts to change to carried interest taxation, insisting that any changes be included as part of comprehensive tax reform.

C. During his campaign, President-elect Donald Trump expressed support for changing carried interest taxation, as well as for broader tax reform.

D. Current Senate and House policymakers have also advocated for broad tax reform to be enacted in the 2017-2018 session.

E. There appears to be an alignment of interests which could lead to the enactment of carried interest legislation.

II. Camp Proposal for Carried Interest

A. A carried interest proposal introduced by Rep. Dave Camp ("Camp Proposal") as part of his noteworthy Tax Reform Act of 2014 has been suggested as a basis for any forthcoming legislation.

B. Basic premise of the Camp Proposal: In principle, manager is entitled to capital gains treatment for carried interest, even though the profits interest is awarded for rendering services.

C. However, investors are viewed as effectively having "loaned" to manager a percentage of their invested capital for purposes of co-investing with them.

D. For example, a manager entitled to a 20-percent carried interest has really "borrowed" 20 percent of the investors' capital (on a non-recourse basis) to co-invest with them, and in essence, the manager's carry is the return on the "borrowed" capital.

E. The Camp Proposal reasons that, because the investors' "loan" to the manager is on an interest-free basis, the manager should be required to account for profits equal to the benefit of the forgone "interest," which the Camp Proposal sets at a rate equal to the applicable federal rate plus 10 percent, as ordinary income.

F. Therefore, the manager is entitled to use any applicable capital gains rate on profit allocations, or gains on disposition of the carried interest, in excess of the cumulative forgone "interest."

III. Scope of Funds Covered by Camp Proposal

A. The Camp Proposal applies to any partnership interest held in connection with performance of services in a trade or business conducted on a regular, continuous and substantial basis, consisting in whole or in part of:

1. Raising or returning capital;

2. Investing in, or disposing of, trades or businesses (or identifying trades or businesses for investment or disposition); and

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3. Developing such trades or businesses.

B. According to the Joint Committee on Taxation, the Camp Proposal doesn't apply to carried interest with respect to an "activity that does not rise to level of a trade or business."

C. The Joint Committee further explains: "For example, an investment, expenses for which are deductible under section 212 but are not deductible under section 162, is not an applicable trade or business" subject to these rules.

D. What funds are included or excluded? Public statements accompanying the Camp Proposal indicated that the intention was to include private equity funds and to exclude real estate funds.

E. Unclear if the statutory language of the Camp Proposal actually accomplishes this.

F. Are hedge funds covered? Does a typical hedge fund invest in, dispose of, or develop trades or businesses?

IV. Some Thoughts Regarding Camp Proposal

A. Note that the Camp Proposal does not directly address "enterprise value" issue, the likely rationale being that forgone "interest" equivalent deserves to be taxed at ordinary rates regardless of source.

B. Like several other carried interest proposals, the Camp Proposal overrides generally applicable gain nonrecognition rules for carried interest dispositions; unclear why this is necessary or appropriate.

C. Potential conflict issue: The Camp Proposal can penalize a private equity manager for holding portfolio investment for longer period, since ordinary income component of carry increases with the passage of time.

D. If the Camp Proposal is applicable to hedge funds, does it apply fund-wide or should it be investor-specific? Should carry earned from a new investor be characterized as ordinary income because of forgone "interest" attributable to older investors?

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Attracting and Retaining Capital

I. New and Noteworthy

A. Growth

1. Growth in both recruiting new investors and additional investments from exiting investors continues to be a high priority for managers.

2. Many managers are offering a variety of investment options in order to appeal to a large spectrum of investors. These options include a class that participates in more liquid investments and a class that participates in less liquid investments but is subject to a lower management fee and/or incentive compensation.

B. Incentive Compensation

1. High Water Mark Carryover: Some managers have been willing to carry over an investor's existing high water mark to any new investment by such investor.

2. Hurdle: Additionally, some managers have added a hurdle to the incentive calculation. This has now expanded beyond long-only products.

C. Aggregation

1. Many managers have ceded to investors' request to be aggregated for purposes of determining: (i) the amount the investors can redeem pursuant to an investor-level gate; and/or (ii) the amount of their investment for purposes of any potential fee breaks, MFN rights and transparency.

2. Investors who are managed or advised by the same adviser on a discretionary basis are then aggregated and treated as a single investor in determining the aggregate investment by those investors.

D. Funds of One and Managed Accounts

1. It has become common for managers to create funds of one or managed accounts to accommodate investors.

2. Managers have: (i) launched a fund of one or managed account up front for an investor; and/or (ii) agreed to convert/transfer a large investor's investment in a fund to a fund of one or managed account once it reaches a certain size.

E. Types of Funds/Products

1. Global macro funds, funds that predominantly make private investments, quant funds, sector funds and activist funds have been attracting the most attention from managers and investors.

2. Managers continue to serve as sub-advisers for 1940 Act regulated funds.

3. Managers have also launched insurance dedicated funds either as part of a third-party sponsored platform or as a stand-alone product.

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4. Some managers have launched UCITS products and business development companies.

5. Some managers have also started to focus on risk retention.

F. Private Equity Light Funds: A number of managers are also launching private equity light funds — these funds have a much shorter investment term than regular private equity funds.

G. Co-investments

1. Managers have offered co-investment opportunities to investors.

2. Some managers have set up platforms to accommodate co-investment opportunities on a short time frame.

II. Market Check

A. Side Letters

1. Larger institutional investors remain likely to request material changes to fund terms and side letters, including:

(a) Greater transparency on the business of the manager and the operation of the fund, including disclosure in connection with:

(i) "Regulatory events";

(ii) General partner/manager/principal redemptions;

(iii) Changes in service providers;

(iv) Crossing concentration or leverage thresholds;

(v) Changes in the allocation policy of the manager with respect to the fund;

(vi) Changes in the valuation policy of the fund; and

(vii) 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 (e.g., in respect of fees, liquidity and transparency), and any parallel vehicles 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) Reduction in the management fee rate when redemptions from the fund are suspended.

(g) Right to inspect the books and records of the fund.

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2. Managers are continuing to build side letter terms into the fund's confidential memorandum to provide all investors with the same terms.

B. Management Fee and Incentive Compensation

1. Management Fee

(a) Some managers are still attempting to charge a 2-percent management fee. However, many of these managers typically offer discounts to early stage and/or large investors.

(b) In addition, investors have required some managers to scale down the management fee rate if their investment in the fund reaches a certain size (see "Fee Breaks" below) or if the fund itself or firm assets under management reaches a certain size.

(c) Some managers have unilaterally reduced the management fee in order to retain capital.

2. Incentive Compensation

(a) Incentive compensation base rates have remained at 20 percent of profits over a traditional high water mark. However, managers typically offer discounts to early stage and/or large investors.

(b) In addition, a few managers have agreed to a tiered incentive compensation (i.e., first 10 percent of profits are subject to a 10-percent incentive fee or allocation, then the next 10 percent of profits are subject to a 20-percent incentive fee or allocation and any additional profits are subject to a 30-percent incentive fee or allocation).

(c) Some managers have added a hurdle to the incentive calculation as noted above under "New and Noteworthy."

3. Some new funds have offered a suite of different management fee and incentive compensation combinations for an investor to choose from (e.g., X-percent management fee with a Y-percent incentive allocation or Z-percent management fee with an A-percent incentive allocation).

4. Fee Breaks

(a) Managers have remained willing to agree to management fee/incentive compensation discounts for early stage and/or large investors.

(i) In determining whether an investor is a "large" investor, managers often look at the overall relationship with the manager and its funds.

(ii) Managers often look at the amount of an investor's investment on an aggregate basis across all of the funds and accounts managed by the same manager.

(b) More often management fee/incentive compensation discount terms may be disclosed in the fund's confidential memorandum (as opposed to a supplement or side letter) to provide transparency to all investors.

These terms may be offered to all investors who meet a certain investment threshold.

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5. Conduit Funds

    (a) Some managers are continuing to accommodate large investors who request a single fund (a "conduit fund") to facilitate investment in multiple funds managed by a single manager or multiple advisory clients.

    (b) A conduit fund allows an investor to get the benefit of paying the management fee and being subject to the incentive compensation on an aggregated basis (i.e., the investor would pay the management fee and incentive compensation on an aggregate basis taking into account its entire investment in the multiple funds if the management fee and incentive compensation are calculated at the conduit fund level).

    (c) As a result, 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.

    (d) A conduit fund may be viewed as an affiliate of the manager and, as such, the money that is invested through the conduit fund would not be able to count in determining whether the fund meets requirements under the 25-percent ERISA test.

C. Founders' Classes

1. Managers that are launching new funds 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.

    (d) It is still difficult to determine which combination of terms leads to successful fundraising.

2. Expiration of Founders' Classes

    (a) Founders' classes sometimes have an expiration that is tied to the fund or the firm reaching a certain level of assets under management or a time period (or both). For example, the expiration could be tied to the firm 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 for new investors, 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.

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D. Liquidity

1. Redemption Terms

(a) Redemption terms have remained closely aligned to the fund's investment portfolio and/or investment 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 investment strategy and investment horizon.

(c) Some managers have been going back to existing investors to structure and create more appropriate liquidity.

2. Lock-up Periods

(a) Lock-up periods are common.

(b) An initial one-year lock-up period in addition to a 25-percent investor-level gate is typical.

(c) Managers may ask for longer lock-up periods in exchange for discounts on the management fee and/or incentive compensation in their founders' classes (as discussed above).

3. 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 and is paid to the fund for the benefit of the non-redeeming investors.

(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, without being subject to a redemption charge.

4. Terms Applicable to Internal Capital Invested in the Fund

(a) Investors remain focused on internal capital (i.e., general partner/principal) and the redemption terms applicable thereto.

(b) Often with new launches, internal capital typically has the same liquidity as that of third-party investors (with an exception for the incentive allocation).

Also if the general partner does not withdraw the incentive allocation within a certain time frame after it is allocated, then such amount also often becomes subject to the same liquidity terms as the fund's third-party investors.

(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 allocation. The carve-outs sometimes also include capital redeemed to invest in new products.

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(d) When necessary (e.g., in connection with a large seed investment), 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.

E. Private Investments

1. Managers have continued to show a strong interest in less liquid and private investments.

2. Investments are made most often through a separate vehicle (e.g., co-investments, sidecars and traditional private equity funds). These investments may also be made: (i) in the general investment portfolio of the fund; or (ii) by re-introducing side pocket provisions into the fund.

3. Liquidity and fiduciary issues potentially arise if the fund does not have side pocket mechanics and instead makes these investments through the general investment portfolio of the fund.

4. A side pocket (aka, a special investment) is a mechanism used by the fund to segregate less liquid (or difficult to value) investments from the liquid portion of the fund's investment portfolio. Since the side-pocketed investment is segregated from the rest of the fund's investment portfolio, 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, incentive compensation on any gains on the side-pocketed investment is not taken until the time of realization.

5. Investors still strongly disdain 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.

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Credit and Hybrid Funds

I. Credit Funds

A. Long-standing credit managers continue to launch new vintages of credit funds and are pursuing new strategies, and new managers are entering the credit space. Managers are pursuing a variety of liquid and illiquid credit strategies. According to one survey, a key trend in credit has been the continued growth of the institutional lending landscape, with numerous funds being raised globally and increasing interest in private lending strategies by investors globally. The other two strategies that institutional investors indicated they expect to invest in over the next few years are mezzanine and distressed debt strategies.

1. More liquid investments include debt securities (publicly traded debt, bonds), credit default swaps, asset-backed securities (RMBS, CMBS, CLOs, CDOs), high-yield instruments, government-issued debt, certain bank debt and debt-related derivatives.

2. Less liquid investments include private debt (commercial and corporate loans), direct lending, secondary purchases of bank debt, distressed debt investments, mezzanine loans and other subordinate debt, residential loans and pools of non-performing loans and loan participations.

3. Credit funds pursue a wide variety of strategies, including, among others, long/short, stressed and distressed debt, private lending, event-driven, special situations, structured credit, bankruptcy or liquidating business-related strategies, regulatory capital investments, mezzanine, leveraged loan and leveraged yield and residential loan (performing, re-performing, sub-performing, non-performing).

B. Fund structures vary depending on the strategy being pursued.

1. Funds function typically as open-ended or closed-ended with terms that are associated with one or the other, as described below. However, since 2009, when a number of hedge funds experienced redemptions in an illiquid credit market, many managers have set up "hybrid" funds that combine the flexibility of the open-ended structure with attractive features of the closed-ended structure, including drawdown features (so that managers have a runway to draw down capital and invest in a more measured manner) and longer lockups with less liquidity (so that managers do not find themselves in a similar position as 2009).

2. Hybrid funds may also have greater flexibility in their investment programs. While liquid funds are expected to invest in liquid investments, such as publicly traded bonds, and less liquid funds are more likely to invest in private debt, a hybrid fund, given the nature of its terms and investment horizon, will be able to pursue both types of investments.

3. Liquid strategies are structured as open-ended "hedge funds." An open-ended credit fund typically includes the following terms:

(a) Subscriptions: Capital is accepted on a monthly basis.

(b) Term: Funds are evergreen with no fixed term.

(c) Redemptions: Regular liquidity for investors (quarterly or even monthly redemptions).

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(d) Incentive Compensation: Incentive compensation is paid or allocated on an annual basis on both realized and unrealized gains. The manager receives its incentive compensation on a mark-to-market basis.

(e) Management Fees: Management fees are based on the net asset value of the investors' interests in the fund.

(f) Investment Guidelines: Typically have loose guidelines in the prospectus or marketing materials that change over time.

4. Illiquid strategies are structured as closed-ended "private equity funds." A closed-ended credit fund typically includes the following terms:

(a) Capital Commitments: Investors make capital commitments that can be called down for a fixed period of time — from two to four years. After the investment period, capital can be called for limited purposes.

(b) Term: Funds have a fixed term — from five to 10 years.

(c) Redemptions: No liquidity for investors.

(d) Incentive Compensation: Incentive compensation is paid as investments are realized and capital is distributed to investors, typically with interim tax distributions to the manager to cover any current taxation on income allocated to the manager relating to such "carried interest."

(e) Management Fees: Management fees are based on commitments during the investment period and cost of investments thereafter.

(f) Investment Limitations: Typically have concentration and other limits set forth in the operating agreement that must be complied with.

5. Less liquid strategies, or funds that pursue multiple credit strategies, are structured as a "hybrid" of open-ended and closed-ended. Hybrid funds vary widely in their terms, as managers mix and match terms that are seen in open-ended and closed-ended funds. Hybrid hedge funds tend to combine investing flexibility with longer-term sources of capital than a standard hedge fund. An example of a hybrid fund terms includes:

(a) Capital Commitments: Investors make capital commitments that can be called down over a period of time.

(b) Term: Funds have a fixed term — from five to seven years.

(c) Redemptions — Limited Liquidity for Investors: Hybrid funds often contain one or more of the following limits on withdrawals: (i) long lockups (typically matching the investment period); (ii) longer notice periods (90 to 120 days); (iii) investor-level and/or fund-level gates; (iv) side pocket mechanics; (v) fast-pay slow-pay mechanics; and (vi) ability for remaining investors or the fund to buy redeeming investors' interests.

(d) Incentive Compensation: Annual incentive compensation is based on realized and unrealized gains.

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(e) Management Fees: Management fees are based on the net asset value of the investors' interests in the fund.

(f) Investment Guidelines: Typically have guidelines that change over time.

6. In all cases, any liquidity terms offered to investors need to be analyzed to ensure that the fund, if intended to be a partnership for U.S. tax purposes, is not treated as a publicly traded partnership that is taxable as a corporation.

II. What Is a "Debt-for-Equity" Swap?

A. A debt-for-equity swap generally refers to a transaction where a debt instrument is converted into equity, either by the borrower or by lender action, typically as part of a restructuring transaction.

B. Debt-for-equity swaps are often consensual (e.g., a friendly foreclosure with borrower or a credit bid in a bankruptcy sale). But they can also be nonconsensual (e.g., a so-called "cram-down" plan under Chapter 11 of the Bankruptcy Code).

C. Debt-for-equity swaps typically occur in the following contexts:

1. A *"friendly foreclosure"* where existing equity owners (typically a private equity sponsor) agree either to "hand the keys over" to lenders or dilute their equity in exchange for debt relief;

2. A *foreclosure sale* under Article 9 of the Uniform Commercial Code, where a secured lender, after a default, can seek to sell the collateral in a commercially reasonable sale and can buy the collateral using the loan as purchase price currency (i.e., credit bid). *See* U.C.C. §§ 9-601(a), 9-609;

3. A bankruptcy *sale under Section 363* of the Bankruptcy Code, where a secured lender can generally "credit bid" for collateral. *See* 11 U.S.C. § 363(k);

4. As part of a *Chapter 11 bankruptcy plan*, where secured or unsecured creditors can agree to convert their debt into equity of the reorganized company (or, in some instances, the company can compel conversion into new equity); or

5. Pursuant to an *exchange offer*, where a company makes an offer to holders of its outstanding debt securities, agreeing to exchange newly issued equity securities for the outstanding debt securities.[1]

III. Why Swap Debt for Equity?

Debt-for-equity swaps may be done for variety of reasons, including:

A. Loan-to-Own Strategy*:* Opportunistic lenders may make a loan to a distressed company or buy the debt of a troubled company at a discount to par with a view towards converting their debt into an ownership stake in the event of a restructuring.

B. Balance Sheet Deleveraging: The borrower may use Chapter 11 to convert debt to equity as part of a restructuring plan to reduce debt.

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[1] Debt exchange offers are consensual, although there may be coercive features to incentivize participation, and do not implicate many of the issues discussed herein. Thus, the impacts of converting debt to equity pursuant to an exchange offer are outside the scope of this outline.

C. Down Market/Bridge to Sale to Future Buyer: The borrower may be stuck in a down-cycle (e.g., an oil drilling company in a low-commodity-price environment). If there are no buyers, the company or lenders will have to de-lever the balance sheet or risk liquidation.

IV. Who Decides?

A. The decision to swap debt for equity is a critically important issue for each individual lender, but in many scenarios (other than the "friendly foreclosure" context), the decision can be made by the "requisite lenders" (usually defined as a simple majority in most loan agreements).

B. While loan agreements differ, most agreements provide that decisions relating to the enforcement of remedies after an event of default are exercised by the agent in its discretion or at the direction of the requisite lenders. Since a credit bid by the agent is a form of exercise of remedies against the collateral, the agent may do so in its discretion or at the direction of the "requisite lenders" (whichever is permitted or required by the loan agreement).

C. Thus, in the context of an Article 9 foreclosure sale or in a sale under Section 363 of the Bankruptcy Code, case law generally supports the ability of the "requisite lenders" to direct to agent to "credit bid" and to "drag along" unwilling minority position lenders.

D. The theory of these cases is that each individual lender has irrevocably delegated authority and control over certain actions (including credit bid) to the agent to act at the direction of the requisite lenders. Such actions are taken on behalf of all lenders, and not just the willing. *See*, e.g., *In re Chrysler LLC*, 405 B.R. 84 (Bankr. S.D.N.Y. 2009), *aff'd* 576 F.3d 108 (2d Cir. 2009) (loan documents gave administrative agent exclusive authority to act at direction of requisite lenders); *In re GWLS Holdings*, No. 08-12430, 2009 WL 453110 (Bankr. D. Del. Feb. 23, 2009) (security agreement granted agent right to credit bid all of the debt); *In re Metaldyne Corp.*, No. 09-13412, 2009 Bankr. LEXIS 2131 (S.D.N.Y. Aug. 12, 2009) (each lender delegated authority to agent to credit bid for assets).

E. Where a debt for equity conversion is sought to be implemented through a Chapter 11 bankruptcy plan, each lender has the right to vote to accept or reject the plan. *See* 11 U.S.C. § 1126(a). Lenders under a single credit agreement will be classified together and the class is deemed to accept a plan if accepted by at least two-thirds in amount and one-half in number of those claimants in the class that actually vote to accept or reject the plan. *See* 11 U.S.C. § 1126(c).

V. Allocation of New Equity in Foreclosure Sale or Credit Bid Context

A. Once the lenders have successfully credit bid for the collateral (whether in a foreclosure sale or a Section 363 sale in bankruptcy), the requisite lenders will almost always form an acquisitive vehicle to hold, maintain and preserve the value of collateral.

B. Typically, the equity in the acquisition vehicle will be distributed to lenders on a pro rata basis consistent with their respective ownership of the debt. This is because loan agreements typically contain sharing provisions that provide that if any lender receives more than its ratable share of proceeds of collateral from the borrower, it has to share the excess with the other lenders.

C. The effect on the minority is significant. The minority lenders' debt will effectively be converted into a minority illiquid equity stake in a private company.

D. Tax Considerations

1. Careful consideration will need to be given as to the taxability to taxable U.S. investors of the exchange of debt for equity.

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2. If the equity is in an entity that is not a corporation for U.S. tax purposes, the equity may generate "effectively connected income" taxable to non-U.S. persons and/or "unrelated business taxable income" to tax-exempt U.S. persons, unless a blocker structure is used.

3. If the issuer of the equity is a U.S. entity that is taxable as a corporation, are there any FIRPTA issues?

4. If any debt of the issuer is being held post-restructure, will the interest on the debt qualify for the portfolio interest exemption from U.S. withholding tax?

VI. Governance of the Acquisition Vehicle

A. The details of corporate governance of the acquisition vehicle is often left to negotiation among the lenders because the credit agreement, which governed a lending relationship, is of little help to determine voting and other corporate governance issues related to the acquisition vehicle.

B. Credit documents usually do not specify the collateral agent's rights, powers and duties after a successful credit bid because the credit agreement is intended to govern a lending relationship.

C. In more recent loan agreements, the agent is specifically authorized to form one or more acquisition vehicles to make the credit bid and to adopt documents providing for the governance of the acquisition vehicle or vehicles (with governance typically vested in the requisite lenders).

D. Credit documents, however, often afford the collateral agent the ability to exercise rights and powers that are "reasonably incidental" to the enumerated powers. Parties may therefore dispute the scope of those powers that are "reasonably incidental" to the enumerated powers. *See,* e.g., *Beal Sav. Bank v. Sommer*, 865 N.E.2d 1210 (N.Y. 2007) (credit agreement that authorized the agent to exercise powers that were specifically delegated "together with such powers as may be reasonably incidental thereto" operated as a "broad grant of power" permitting the agent's entry into a settlement over dissent of minority of lenders).

E. It is common for voting rights to track voting terms of a credit agreement. Thus, if the credit agreement was governed by "majority rule," the acquisition vehicle will usually be governed by majority rule.

F. The initial board of directors/managers will typically be appointed by the majority lenders (now new equity investors). The new board of directors/managers will have broad discretion to dictate corporate governance, including capital raises and other business transactions.

G. Minority lenders, once equitized, likely will have to rely on general corporate law protections to safeguard their interests. Minority shareholders may have rights under applicable state law to address a breach of fiduciary duty by the board and, in some states, a majority shareholder may owe a fiduciary duty to minority holders. For example, under Delaware law, a stockholder owes a fiduciary duty to other stockholders only if it owns a majority interest in, or exercises control over the business affairs of, the corporation. *Kahn v. Lynch Comm. Sys., Inc*., 638 A.2d 1110, 1113-15 & 1121-22 (Del. 1994); *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1344 (Del. 1987).

VII. Post-swap Capital Needs

A. Before the credit bid sale is consummated, the lenders should consider the capital needs of the acquisition vehicle. If the acquired collateral is an ongoing business, it will need working capital to operate. Even if the acquired collateral is not an operating business (e.g., real estate, litigation claims or accounts receivable), the acquisition vehicle will still need access to capital to preserve and maintain the collateral pending further disposition.

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B. Raising capital, like governance issues, can raise complicated issues especially when the capital is provided by only a subset of the existing lenders. In these circumstances, there is a risk that the minority lenders (now minority equity holders) will be primed by a new debt financing or diluted by a new equity capital. In this scenario, minority lenders may wish to participate in a capital raise to avoid dilution to their investment.

C. Any such financing needs to be reviewed from a tax standpoint, including whether it may be properly viewed as an investment made to protect the taxpayer's existing investment.

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Regulatory Outlook

I. Regulatory Outlook

A. Outlook for New Regulations

1. Rules that have been proposed by the Securities and Exchange Commission (the “SEC” or the “Commission”) but not yet adopted:

(a) *Business Continuity and Transition Plans*.[1] This proposed rule would require SEC-registered investment advisers to adopt and implement written business continuity and transition plans reasonably designed to address risks related to a significant disruption in the investment adviser’s activities and succession planning. The proposed rule would also amend the SEC’s books and records rule to require record keeping of the business continuity and transition plan, as well as recordkeeping of certain communications related to performance marketing.

(b) *Use of Derivatives by Registered Investment Companies and Business Development Companies*.[2] This proposed rule would establish new limitations on the use of derivatives by registered investment companies and business development companies, and regulate other trading practices of such funds (including short sales of securities) that are deemed to involve the issuance of “senior securities.”

(c) *Incentive Compensation*.[3] Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) requires several agencies (including the SEC) to issue rules imposing restrictions on incentive-based compensation for employees of financial institutions, including banks, registered broker-dealers and investment advisers. The proposed rule applies to “covered” financial institutions, which must have $1 billion or more in assets, with enhanced requirements for institutions with over $50 billion in assets and those with over $25 billion in assets. Notably, these asset thresholds exclude client assets under management and only include proprietary assets.

2. SEC Rules Discussed But Not Yet Proposed

(a) *Third-Party Reviews of Investment Advisers*. In response to repeated criticism of the SEC as to the low percentage of advisers examined, Chair White asked the Commission staff to develop a proposal for mandatory third-party compliance reviews of investment advisers.[4] Other commissioners have, at various times, expressed support for such a measure.[5]

(b) *Short Sale Disclosure*. Section 929X of the Dodd-Frank Act requires the SEC to prescribe rules providing for the public disclosure, on at least a monthly basis, with respect to all listed

[1] Investment Advisers Act Release No. IA-4439, 81 Fed. Reg. 43530 (July 5, 2016).

[2] Investment Company Act Release No. IC-31933, 80 Fed. Reg. 80884 (Dec. 28, 2015).

[3] Investment Advisers Act Release No. IA-4383, 81 Fed. Reg. 37670 (June 10, 2016).

[4] *See* Mary Jo White, Chair, U.S. Sec. & Exch. Comm’n, Remarks at Beyond Disclosure at the SEC in 2016, Washington, DC (Feb. 19, 2016), *available at* www.sec.gov/news/speech/white-speech-beyond-disclosure-at-the-sec-in-2016-021916.html (Chair White noting that she intends to “bring forward a workable program for third party reviews to enhance the compliance of registered investment advisers”).

[5] Daniel M. Gallagher, Comm’r, Sec. & Exch. Comm’n, Remarks at the 46th Annual Rocky Mountain Securities Conference, Denver, Colorado (May 9, 2014) *available at* www.sec.gov/News/Speech/Detail/Speech/1370541779229 (Commissioner Gallagher noting that third-party examiners of investment advisers can be helpful in addressing the imbalance of enforcement actions between broker-dealers and investment advisers).

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securities, the name of the issuer and the title, class, CUSIP number and information regarding the aggregate number of short sales of the subject security, as well as additional information that the SEC may require. It is unclear whether such rules would require reporting on an investor-level basis, an issuer-level basis or both.

(c) *Requirements of Exempt Reporting Advisers*. Section 408 of the Dodd-Frank Act amended Section 203 of the Advisers Act to exempt advisers solely to private funds with less than $150 million in regulatory assets under management in the United States from registration with the SEC as investment advisers (this exemption is the "Private Fund Adviser Exemption"). In doing so, Section 203(m)(2) of the Advisers Act gives the SEC the authority to require advisers relying on the Private Fund Adviser Exemption "to maintain such records and provide to the Commission such annual or other reports as the Commission determines necessary or appropriate in the public interest or for the protection of investors." To the extent that additional categories of investment advisers (e.g., advisers to private equity funds) are exempted from registration with the SEC, it is possible that the SEC may rely on its authority under Section 203(m)(2) of the Advisers Act to mandate additional reporting from such exempt advisers than is currently required for exempt reporting advisers.

3. Recent CFTC Proposed Rulemaking

(a) *Regulation AT*. On Dec. 17, 2015, the U.S. Commodity Futures Trading Commission (the "CFTC") issued a proposed rule ("Regulation AT") that would impose a series of risk controls, transparency measures and other controls upon algorithmic traders. In November 2016, the CFTC proposed a supplemental notice of proposed rulemaking that responded to industry comments by defining the coverage thresholds, reducing the number of control levels in the proposed risk control framework and requiring commission-level approval for a source code inspection demand. Many industry participants continue to have concerns about several aspects of the proposed rule and it is unclear whether the next commission will continue to advance this rulemaking.

(b) *Expanded Position Limits*. On Dec. 5, 2016, the CFTC re-proposed rules that would, if adopted, expand the scope of the existing federal position limits regime for exchange-traded futures contracts. This re-proposal, among other things, would increase, to 25, the number of contracts that are subject to speculative position limits and require their economically equivalent "referenced contracts" to count towards such limits. As with the Regulation AT proposal, it is unclear whether the next commission will continue to advance this rulemaking.

(c) *Position Limit Aggregation*. On Dec. 5, 2016, the CFTC finalized determining which positions and accounts must be aggregated when calculating compliance with position limit rules. The new rules require aggregation in a number of situations where a "control" relationship or "substantially similar" trading is found. The new rulemaking also clarifies the operation of common aggregation exemptions and will require several categories of traders to make filings to claim an exemption.

4. Potential Dodd-Frank Act Revisions

(a) On Sept. 10, 2016, the House Financial Services Committee approved H.R. 5983, the Financial CHOICE Act of 2016.[6] The Financial CHOICE Act contains various revisions to the Dodd-Frank Act, and several provisions relevant to private fund advisers. The Financial CHOICE Act has

[6] Financial CHOICE Act of 2016, H.R. 5983, 114th Cong. (2016).

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been reported to the House of Representatives by the Financial Services Committee, but has not been voted upon.

(b) Two provisions relevant to private funds advisers are Sections 450 and 452 of the Financial CHOICE Act.

(i) Section 450 of the Financial CHOICE Act exempts advisers to private equity funds from the registration and reporting requirements of Section 203 of the Advisers Act. The Financial CHOICE Act also requires the SEC to issue rules within six months after the date of enactment that: (i) require investment advisers to private equity funds to maintain records and provide to the SEC reports that the SEC, taking into account fund size, governance, investment strategy, risk and other factors, determines necessary and appropriate; and (ii) defining the term "private equity fund" for the purpose of the exemption.

(ii) Section 452 of the Financial CHOICE Act expands the definition of an accredited investor to include natural persons who: (i) are currently licensed or registered as a broker or investment adviser by the SEC, the Financial Industry Regulatory Authority ("FINRA"), an equivalent self-regulatory organization ("SRO") or a state securities regulator; or (ii) the SEC determines by regulation have demonstrable education or job experience to qualify as having professional knowledge of a subject related to a particular investment, and whose education or job experience is verified by FINRA or an equivalent SRO.

(c) Certain additional provisions contained in the Financial CHOICE Act:

(i) Repeal of the authority of the Financial Stability Oversight Council ("FSOC") to designate non-banking companies, payments and clearing organizations as "Systemically Important Financial Institutions."

(ii) Repeal the FSOC's authority to designate particular activity as subjected to heightened prudential standards (which would permit the FSOC to prohibit such activity).

(iii) Re-establish the Consumer Financial Protection Bureau as an independent agency led by a bipartisan, five-member commission known as the "Consumer Financial Opportunity Commission." The new agency would be funded through Congressional appropriations, and charged with protecting consumers and promoting market competition.

(iv) Restructure the internal organization and processes of both the SEC and the CFTC for the purposes of making the operations of both agencies more efficient.

(v) Repeal of the Volcker Rule.

(vi) Overturn the Supreme Court's decision in *Chevron*[7] requiring judicial deference to agency interpretations by altering the standard of judicial review in the Administrative Procedure Act in its application to financial regulatory agencies.

(vii) Require that all "major" financial regulations[8] receive affirmative Congressional approval prior to becoming effective.

[7] *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984).

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(viii) Increase the SEC's enforcement authority to authorize stiffer penalties for certain categories of securities law violations and authorize a fourth tier of damages for repeat offenders.

(ix) Grant the SEC authority to perform risk-based examinations of credit rating agencies.

(x) Repeal Section 929X of the Dodd-Frank Act, as described above.

(xi) Exempt all non-residential mortgage asset classes from Dodd-Frank's risk retention requirements for asset-backed securities.

B. Outlook for SEC Examinations

1. Resources for SEC Examinations of Investment Advisers

(a) Over the past several years, the SEC's Office of Compliance Inspections and Examinations ("OCIE") has substantially grown in size and budget.

(b) Each year, the SEC must provide a budget request and justification to Congress. From 2015 to 2017, over 50 percent of the new positions that the SEC requested have been for OCIE.[9] This is in contrast with the SEC's requests from 2011 to 2013, where 25 percent to 33 percent of the new positions that the SEC requested have been for OCIE.[10]

(c) The number of positions in OCIE has grown, in absolute terms, by 26 percent from 2011-2016.[11] OCIE has an estimated 1,145 enacted positions through fiscal year 2016.[12]

(d) OCIE's budget allocation for 2016 was approximately $315 million.[13] Since 2011, OCIE's budget has risen by approximately 20 percent.[14]

(e) Marc Wyatt, the current director of OCIE, noted in a recent speech that, effective in FY 2017, OCIE has increased staffing in the investment adviser/investment company examination program by approximately 20 percent.[15] Mr. Wyatt further noted that a significant number of

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[8] I.e., those likely to result in: (1) an annual economic impact of more than $100 million; (2) a major increase in prices for consumers or costs for businesses; or (3) significant adverse effects on competition, employment, investment, productivity or innovation or international competitiveness.

[9] *See* U.S. Sec. & Exch. Comm'n, FY 2017 Congressional Budget Justification 17 (2016) (hereinafter "2017 Budget Justification"); U.S. Sec. & Exch. Comm'n, FY 2016 Congressional Budget Justification 17 (2015) (hereinafter "2016 Budget Justification"); U.S. Sec. & Exch. Comm'n, FY 2015 Congressional Budget Justification 17 (2014) (hereinafter "2015 Budget Justification").

[10] *See* U.S. Sec. & Exch. Comm'n, FY 2013 Congressional Budget Justification in Brief 15 (2012) (hereinafter "2013 Budget Justification"); U.S. Sec. & Exch. Comm'n, FY 2012 Congressional Budget Justification in Brief 12 (2011) (hereinafter "2012 Budget Justification"); U.S. Sec. & Exch. Comm'n, FY 2011 Congressional Budget Justification in Brief 11 (2010) (hereinafter "2011 Budget Justification").

[11] *Compare* 2013 Budget Justification at 12 *with* 2017 Budget Justification at 14.

[12] 2017 Budget Justification at 14.

[13] *Id.*

[14] OCIE's budget for FY 2011 was approximately $259,937,000, in comparison with a FY 2016 budget of $315,293,000. *Compare* 2013 Budget Justification at 14 *with* 2017 Budget Justification at 14.

[15] Marc Wyatt, Dir., Off. of Compliance Inspections and Examinations, U.S. Sec. & Exch. Comm'n, Keynote Address at National Society of Compliance Professionals 2016 National Conference, Washington, D.C. (Oct. 17, 2016), *available at* www.sec.gov/news/speech/inside-the-national-exam-program-in-2016.html.

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the new investment adviser/investment company examiners are being transitioned from OCIE's broker-dealer examination program.[16]

2. Referrals to Enforcement

(a) In 2016, Andrew Ceresney, the former director of the SEC's Division of Enforcement (the "Enforcement Division") noted that trends identified by OCIE led the Enforcement Division's Asset Management Unit to investigate and bring its series of high-profile cases against private equity fund managers.[17]

(b) In FY 2015 (the most recent year for which data is available), 11 percent of OCIE examinations led to referrals to the Enforcement Division.[18]

3. Common SEC Examination Focus Areas

(a) Expense Allocations

OCIE has focused on expense allocations in examinations of both private equity sponsors and hedge fund managers. Expenses were identified in the "Examination Priorities for 2016" list and this focus on expenses was present during examinations that took place in 2016. 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.

(b) Valuation

(i) OCIE has been reviewing valuation processes, including any gaps between the valuation procedures as disclosed to investors and as carried out in practice.

(ii) OCIE has also been examining, and sometimes challenging, the valuation methodologies used and the valuations themselves.

(c) Compliance Program

(i) 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."

(ii) Deficiency letters have increasingly identified perceived deficiencies in the knowledge and qualifications of chief compliance officers.

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[16] *Id.*

[17] *See* Andrew Ceresney, Dir., Div. of Enforcement, U.S. Sec. & Exch. Comm'n, Remarks at Securities Enforcement Forum West, San Francisco, CA (May 12, 2016), *available at* www.sec.gov/news/speech/private-equity-enforcement.html#_ftnref5.

[18] *See* U.S. Sec. & Exch. Comm'n, FY 2017 Congressional Budget Justification 35 (2016), *available at* www.sec.gov/about/reports/secfy17congbudgjust.pdf.

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(d) Insider Trading

(i) Some recent 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.

(ii) OCIE has also focused on relationships between different buy-side firms, as well as information sharing with investors, and the receipt of confidential information at broker-sponsored conferences and certain industry conferences.

(iii) Examination staff have taken the position in recent examinations that advisers should create and maintain logs of meetings with company management in order to investigate certain trades.

4. OCIE's Private Funds Unit has been made a formal group operating within OCIE with additional staffers.[19]

C. The Division of Investment Management

1. Since the passage of the Dodd-Frank Act, the staff of the Division of Investment Management (the "IM Staff") has had an unprecedented volume of rulemaking responsibilities.

2. The IM Staff has issued several published points of guidance known as "IM Guidance Updates."[20]

3. The Division of Investment Management has a dedicated Private Funds Branch focused on policy issues relating to private fund advisers. These staff members work in tandem with both OCIE (and its Private Funds Unit) and the Enforcement Division (as well as its Asset Management Unit).

II. New Capital Acquisition Broker Rules

A. On Aug. 18, 2016, the SEC approved FINRA's "Capital Acquisition Broker Rules" (the "CAB Rules").[21]

B. The CAB Rules generally become effective April 14, 2017. The CAB Rules will apply to FINRA members that meet the definition of "capital acquisition broker" ("CAB") under FINRA rule 016(c) and have been approved by FINRA to be regulated as CABs. CABs will be subject to a more limited set of rules than other FINRA members.

C. "Capital acquisition broker" is defined by FINRA as a broker that solely engages in certain delineated activities, including advising issuers regarding "securities offering or other capital raising activities" and acting as a placement agent in connection with the sale of newly-issued, unregistered securities to "institutional investors."[22]

[19] Marc Wyatt, Dir., Off. of Compliance Inspections and Examinations, U.S. Sec. & Exch. Comm'n, "Remarks at Private Equity: A Look Back and a Glimpse Ahead," New York, NY (May 13, 2015), *available at* www.sec.gov/news/speech/private-equity-look-back-and-glimpse-ahead.html.

[20] *See,* e.g., Div. of Inv. Mgmt., U.S. Sec. & Exch. Comm'n, IM Guidance Update: No. 2016-05, Staff Guidance Concerning Investment Adviser Reliance On Predecessor Registrations, Nov. 2016; Div. of Inv. Mgmt., U.S. Sec. & Exch. Comm'n, IM Guidance Update: No. 2015-02, Cybersecurity Guidance, Nov. 2016.

[21] *See* Exchange Act Release No. 34-78617, 81 Fed. Reg. 57948 (Aug. 24, 2016).

[22] *See* FINRA rule 016(c).

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1. The term "institutional investor" has substantially the same meaning as that term is defined at FINRA Rule 2210, and includes any person meeting the definition of "qualified purchaser" under Section 2(a)(51) of the Investment Company Act of 1940. The term does not, however, include "accredited investors" (as defined at Rule 501(a) of the Securities Act of 1933, as amended).

2. FINRA noted that it did not believe it was necessary or appropriate to extend the definition of "institutional investor" to include "accredited investors," as accredited investors may not have the requisite investment acumen or financial means to understand or assume the risks associated with investments sold by CABs."[23]

III. Recent Enforcement Actions

A. In FY 2016, the SEC brought a total of 868 enforcement actions, which is a 7.6-percent increase over the previous two years.

B. Notably, a higher percentage of these cases were brought against investment advisers. The Commission brought a record 160 cases against investment advisers or investment companies. That is an increase of 27 percent from FY 2015.

C. The SEC continued the trend of bringing a high volume of cases focused on investment advisers, hedge funds and other private funds in FY 2016.

IV. Areas of Continued SEC Focus

A. Valuation

1. Valuation has long been, and continues to be, an enforcement focus. Marshall S. Sprung, former co-chief of the SEC Enforcement Division's AMU stated, "Fund managers can't tell investors one thing and do another when … valuing assets."[24]

2. Accurate valuation remains vital as the prices at which funds sell and redeem their shares are based upon the fund's net asset value ("NAV").

3. *In the Matter of Calvert Investment Management, Inc.*, Admin. Proc. File No. 3-17630, Oct. 18, 2016.

(a) The SEC brought an enforcement action against Calvert alleging improper valuation of securities issued by Toll Road Investors Partnership II LP. (the "Toll Road Bonds"), which were held by registered investment companies that Calvert advised (the "Calvert Funds"), between March 2008 and October 2011. Calvert's improper valuation led the Calvert Funds to be priced at an incorrect NAV.

(b) When the Calvert Funds executed shareholder transactions based on that incorrect NAV, they stated inaccurate performance figures.

(c) After discovering that it had improperly valued the Toll Road Bonds, Calvert sought to remedy the harm by contributing $27 million to the Calvert Funds, which was distributed to shareholders. While payments were made to compensate shareholders, Calvert did not

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[23] *See* 81 FR at 57957.

[24] *Available at* www.sec.gov/news/pressrelease/2016-11.html.

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precisely calculate fund and shareholder losses in accordance with the Calvert Funds' NAV error correction procedures.

(d) To resolve the proceeding, the firm agreed to a series of undertakings which included recalculating the fair-value price, as well as the NAV, and making appropriate payments to shareholders in accord with procedures specified in the undertakings. Calvert was also censured and fined $3.9 million.

B. Insider Trading

1. Insider trading remains an area of heightened SEC scrutiny. Former Enforcement Director Andrew Ceresney, presenting the SEC's enforcement results for FY 2016, stated, "This has been a strong year for the Enforcement Division, with groundbreaking insider trading … cases."

2. In FY 2016 the SEC charged 78 parties in cases involving insider trading, a number of which involved complex insider trading rings cracked by the SEC's innovative use of data and analytics.[25]

3. The Dec. 6, 2016 Supreme Court decision in *Salman v. United States* is the latest development in the law of insider trading. The narrow decision re-affirmed the "personal-benefit" test articulated in *Dirks v. SEC* and held that evidence of a friendship or familial relationship between tipper and tippee, even in the absence of a pecuniary or tangible benefit, is sufficient to satisfy the *Dirks* "personal benefit" requirement of insider trading liability. The decision did not impact the holding or outcome of *United States v. Newman* aside from overruling *Newman* to the extent *Newman* was read to mean that, to prove an illicit tip in the context of a friendship or familial relationship between tipper and tippee, the government must always show that the tipper received a pecuniary or other tangible benefit.

(a) *United States v. Newman*

The court 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, consequential, and represents at least a potential gain of pecuniary or similarly valuable nature."

(b) *Salman v. United States*

(i) In a decision limited to tipper-tippee liability in the context of trading relatives and friends, the court held that a gift of confidential information is sufficient to fulfill the "personal benefit" requirement of insider trading liability. The court stated that in such situations, the tipper personally benefits because "giving a gift of trading information to a trading relative is the same thing as trading by the tipper followed by a gift of the proceeds."

(ii) The court did not address the government's argument that a "gift of confidential information to anyone," not just a friend or relative, should be sufficient to prove insider trading. The decision left unanswered what "personal benefit" is required for tipper-tippee liability outside the factual scenario presented by *Salman*, specifically whether a

[25] *Available at* https://www.sec.gov/news/pressrelease/2016-212.html

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gift made to individuals other than friends or relatives requires a finding of "something of value" to satisfy the personal benefit element.

4. From a compliance perspective, it is important for investment advisers to make sure that employees are consistently and effectively trained on the legal prohibitions on insider trading. Increased input from compliance and legal professionals on the research process and interactions with paid consultants can decrease the risk of an insider trading issue arising.

C. Disclosure of Conflicts, Fees and Expenses

In 2015, the director of the SEC Division of Enforcement emphasized that the SEC will continue to pursue enforcement actions against advisers that do not adequately disclose fees, expenses and conflicts because "full transparency of fees and conflicts of interest is critical in the private equity industry."[26] The SEC brought high-profile cases against well-known fund managers based on fees and expense practices in 2015,[27] and followed up in 2016 with additional cases.[28]

1. *In re The Robare Group, Ltd.*, Admin. Proc. File No. 3-16047, Nov. 7, 2016.

   (a) The SEC's enforcement action against Robare and its principals (the "Respondents") contended that Respondents negligently failed to fully and fairly disclose potential conflicts of interest arising from a revenue sharing arrangement with Fidelity Investments ("Fidelity"). Under its arrangement with Robare, Fidelity paid Robare for maintaining client assets in certain mutual funds Fidelity offered on its online platform. The SEC charged that the arrangement presented at least a potential conflict of interest whereby Robare had a financial incentive to purchase certain mutual funds over others and to prefer investments offered on Fidelity's platform over those that were not.

   (b) The SEC's view was that the arrangement was material and Robare was required to disclose this arrangement on its Form ADV, which it failed to do for many years. Even after identifying the arrangement ono its Form ADV, the SEC contended Robare's disclosure of the arrangement, that stated it "may" receive additional compensation from Fidelity based on revenue from the sale of funds through Fidelity, was inadequate.

   (c) The Commission imposed a penalty of $50,000 against each Respondent despite the lack of scienter or that the alleged violations involved no concrete economic harm to investors.

2. *In the Matter of Blackstreet Capital Management, LLC,* Admin. Proc. File No. 3-17267, June 1, 2016.

   (a) The SEC contended that Blackstreet Capital Management LLC ("Blackstreet") engaged in conflicted transactions and inadequately disclosed fees and expenses. According to the SEC, Blackstreet:

      (i) Charged fees to portfolio companies in one fund for providing operating partner oversight, but the fund's limited partnership agreement (LPA) did not disclose that Blackstreet received such fees. This allegedly resulted in a conflict of interest because Blackstreet used fund assets to compensate itself;

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[26] *Available at* www.sec.gov/news/pressrelease/2015-235.html.

[27] *See,* e.g., *In the Matter of Kohlberg Kravis Roberts & Co. L.P.* (June 29, 2015); *In the Matter of Blackstone Management Partners L.L.C.*, et al. (Oct. 7, 2015); *In the Matter of BlackRock Advisors, LLC and Bartholomew A. Battista* (April 20, 2015).

[28] *In the Matter of Apollo Management V, L.P. et al.* (Aug. 30, 2016); *In the Matter of WL Ross & Co. LLC* (Aug. 24, 2016).

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(ii) Used fund assets to pay for political and charitable contributions, as well as entertainment expenses. These expenditures were not expressly authorized by the funds' governing documents, and Blackstreet neither sought nor obtained appropriate consent; and

(iii) Engaged in a conflicted transaction when it acquired a departing employee's shares in one fund's portfolio companies without disclosing its financial interests or obtaining appropriate consent to engage in the transaction.

(b) As part of its settlement with the SEC, Blackstreet was censured and required to pay $2.339 million in disgorgement, $283,737 in interest and a $500,000 penalty.

D. Investment Strategy

1. The SEC has continued to scrutinize firms' compliance with their disclosed investment strategies and objectives. Even inadvertent or negligent departures from disclosed strategies have not been accepted by the SEC as excuses to avoid liability.

2. *In the Matter of James Caird Asset Management LLP*, Admin. Proc. File No. 3-17276, June 2, 2016.

(a) Instead of following specified long-term investment strategy, the adviser invested in short-term IPO trades (trades were profitable).

(b) Although the alternate strategy was profitable for one fund, the SEC concluded there were violations because, among other things, a sister fund that was also an investor was not given disclosure about the deviations from the disclosed strategy.

E. Supervisory Liability

1. In 2015, we noted that the SEC had brought a substantial number of enforcement actions against CCOs for compliance failures at their respective firms.[29]

2. *In the Matter of Artis Capital Management, LP and Michael W. Harden*, Admin. Proc. File No. 3-17624, Oct. 13, 2016.

(a) In this case, the SEC alleged that Michael W. Harden, a senior analyst at Artis Capital Management LP ("Artis"), failed reasonably to supervise Matthew Teeple, an Artis employee who procured material nonpublic information from an insider at a public company. Mr. Teeple communicated the material nonpublic information to Artis, which made two trades based on that information. The SEC alleged that Mr. Harden, as the senior analyst, received information from Mr. Teeple on both occasions that should have caused a reasonable supervisor to question where Mr. Teeple received the information. Mr. Harden did not question the source of the information, and as a result, was charged with failure to reasonably supervise Mr. Teeple under Section 203(e)(6) of the Advisers Act. Mr. Harden was suspended from association with any broker, dealer, investment adviser, municipal securities dealer or transfer agent for 12 months and fined $130,000.

(b) In *Artis*, the individual charged was the business supervisor who failed to reasonably supervise an analyst. This underscores the principle that compliance is the responsibility of all members of a firm and cannot be solely delegated to compliance personnel.

[29] *See In the Matter of BlackRock Advisors, LLC and Bartholomew A. Battista* (April 20, 2015); SFX Financial Advisory Management Enterprises, Inc. and Eugene S. Mason (June 15, 2015); Sands Brothers Asset Management et al. (Nov. 19, 2015).

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F. Market Manipulation

1. Exchange Act Rule 15c3-5 requires broker-dealers that provide market access ("Market Access Providers") to establish and maintain "a system of risk management controls … reasonably designed to manage the financial, regulatory, and other risks" of providing market access.

   (a) This includes controls designed: (i) to reject orders that would exceed a customer's pre-set credit limit or that indicate duplicative orders; (ii) to monitor for order and execution activity that might indicate manipulative trading, including potential layering, spoofing and wash sales; and (iii) to ensure that orders comply with all regulatory requirements that must be satisfied on a pre-order entry basis.

   (b) The SEC has found violations of the Exchange Act Rule 15c3-5 where a Market Access Provider allegedly failed to have controls and procedures that were reasonably designed to detect potential wash sales, layering and spoofing activity engaged in by the broker-dealer's customers.[30]

   (c) FINRA has alleged violations of Exchange Act Rule 15c3-5 where a Market Access Provider did not terminate in a timely manner a customer that was generating layering and spoofing alerts at the broker-dealer.

2. The SEC has noted concerns relating to order anticipation and momentum ignition strategies,[31] and continues to review the potential effects of such strategies on market structure and long-term investors.[32]

   Additionally, FINRA has alleged that "excessive" messaging activity violates the Exchange Act Rule 15c3-5,[33] and that broker-dealers have a duty to monitor for, and restrict, excessive messaging activity of the broker-dealer's underlying customers.[34]

V. Commodities Regulation

Focus on Technical Violations in Exchange-Related Enforcement Actions

A. The CFTC and the derivatives contracts markets ("Futures Exchanges") have become increasingly active in seeking enforcement actions against market participants for both technical violations, as well as more substantive manipulation and insider-trading violations. Over the past year, there has been a particular emphasis on technical violations, especially with respect to enforcement actions brought by Futures Exchanges.

B. Many of the Futures Exchanges are owned by the Chicago Mercantile Exchange ("CME Group"). The CME Group is comprised of the CME, Chicago Board of Trade ("CBOT"), New York Mercantile Exchange ("NYMEX") and Commodity Exchange Inc. ("COMEX"), and is tasked with the regulation and enforcement of its members and market activity (of even non-members). The CME Group is subject to oversight by the CFTC and periodic review of its programs. Over the past several years, the CFTC has

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[30] *See* Exchange Act Release No. 34-73652 (Nov. 20, 2014).

[31] 75 FR at 3607, 3609.

[32] *Available at* www.sec.gov/marketstructure/research/hft_lit_review_march_2014.pdf.

[33] *See* FINRA Letter of Acceptance, Waiver and Consent ("AWC") No. 2010022334505.

[34] *See* FINRA Disciplinary Proceeding No. 20090206344-01.

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increased pressure on the Futures Exchanges to devote greater resources to enforcement of violations, even with respect to technical rules. [35]

C. EFRP Violations

1. Exchange for Related Positions ("EFRP") transactions allow investors to exchange futures contracts for their related physical instruments, derivative positions, options or other OTC contracts with similar characteristics.[36] EFRPs have recently been the focus of regulatory actions.

2. In 2016, Futures Exchanges continued to request documentation to verify that EFRP transactions were bona fide transactions and that any EFRP transactions entered into were in accordance with exchange rules. Understanding the various types of EFRPs, having policies in place that distinguish between permitted and impermissible EFRPs, and having effective training with trading and investment personnel are some key components to preventing EFRP infractions. Due to the highly technical nature of EFRP rules, strict liability is generally imposed on violators. Attempting to assert defenses will generally not mitigate liability.

D. Pre-arranged Trades

1. In general, pre-arranged trades are trades where a party's offer to sell a commodity interest is combined with an offer to buy back the commodity interest at the same price or another pre-set price that benefits the entities engaging in the pre-arranged trading. These trades are prohibited by both the CFTC's rules, as well as the rules of various Futures Exchanges.

2. As is the case with EFRPs, enforcement activity with respect to pre-arranged trades is done on a strict liability basis and the Futures Exchanges have been particularly active in pursuing such actions over the past year.

E. SEF Enforcement

1. Swap Execution Facilities ("SEFs") are regulated facilities, trading systems or platforms where multiple participants trade swaps by accepting bids and offers made by multiple participants in the facility. In 2016, SEFs first instituted enforcement actions against members or entities with trading privileges on the SEF. Each SEF has its own rules and enforcement regime to regulate conduct both by members, as well as by any counterparties who trade on the SEF.

2. Similar to the discussion above regarding pre-arranged trades and EFRPs, enforcement actions initiated by SEFs have thus far focused on technical violations of the SEF rules.

F. NFA Examinations

1. The National Futures Association's ("NFA") examination program has become more sophisticated over the past several years and such examinations have become more common.

2. NFA examinations tend to focus on substantive, concrete issues, such as fraud in the futures markets. Technical violations of exchange rules have more commonly been investigated and penalized by the Futures Exchanges.

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[35] *Available at* www.cftc.gov/idc/groups/public/@iodcms/documents/file/rernymex_comex101116.pdf.

[36] CME Group, Exchange for Related Positions ("EFRPs"), *available at* www.cmegroup.com/clearing/trading-practices/efp-efr-eoo-trades.html.

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3. NFA examinations have also become more interdisciplinary — often the SEC will not close an open examination if the NFA is conducting an examination and its results have not been finalized yet.

VI. Enforcement Outlook

A. Self-reporting of Violations

1. There is no statute or regulation requiring advisers to private funds to self-report any securities law violations to the SEC.

2. Broker-dealers are subject to a self-reporting rule: FINRA Rule 4530 requires firms to promptly report if the firm has concluded, or reasonably should have concluded, that the firm or an associated person of the firm has violated any securities, insurance, commodities, financial or investment-related laws, rules, regulations or standards of conduct of any domestic or foreign regulatory body or self-regulatory organization.

3. For a number of years, the SEC has identified potential credit that firms may receive for voluntary self-reporting.[37]

4. The SEC staff has recently emphasized that self-reporting may be a significant factor in the Commission's consideration of whether and to what extent to charge violations.

   In the Matter of WL Ross & Co. LLC, Admin. Proc. File No. 3-17491, Aug. 24, 2016.

   WL Ross settled charges over allegations it failed to disclose fee allocation practices to its funds and investors. "In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by WL Ross and cooperation afforded the Commission staff, including WL Ross' self-reporting of the Transaction Fee allocation issue to the OCIE staff."[38]

5. Impact of Not Self-reporting

   In some recent enforcement matters, the Enforcement Staff have been critical of the advisers' decision not to self-report a violation, despite the lack of an obligation to do so, and the advisers' decision not to self-report was factored into the charges and penalties.

B. CCO Liability

1. The SEC has pursued charges against CCOs, viewing them as important "gatekeepers." In the SEC's 2014 Financial Report 2014, Chair White stated, "The Division of Enforcement continued to mount increasingly sophisticated investigations, redoubling efforts in traditional areas, like accounting fraud, and expanding its focus on gatekeepers who must act in investors' interests."[39] A number of actions against CCOs sparked a public debate. Former Enforcement Director Ceresney highlighted three categories of CCO conduct the SEC is focused on in cases:

   (a) Of affirmative misconduct, apart from the CCOs' compliance role;

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[37] *See* U.S. Sec. & Exch. Comm'n, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions (Oct. 23, 2001) (commonly known as the "Seaboard Report"), *available at* www.sec.gov/litigation/investreport/34-44969.htm.

[38] *Available at* www.sec.gov/litigation/admin/2016/ia-4494.pdf.

[39] Mary Jo White, Message from the Chair, in U.S. Sec. & Exch. Comm'n, Agency Financial Report 2, 2 (2014), *available at* www.sec.gov/about/secpar/secafr2014.pdf.

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(b) Where CCOs try to obstruct or mislead the Commission staff; and

(c) Where CCOs demonstrate a complete failure to carry out their responsibilities, particularly failures arising under Rule 206(4)-7.[40]

2. Of the three categories of conduct referenced by former Enforcement Director Ceresney, while the first two categories are often viewed by CCOs as wrongdoing that CCOs can avoid, the third category effectively opens CCOs to potential liability for compliance program failures.

3. In FY 2016, the SEC has continued to focus on corporate gatekeepers, including CCOs.

   In the Matter of Biscayne Capital International, LLC, Admin. Proc. File No. 3-17263, May 27, 2016.

   (a) The SEC brought an enforcement action against investment advisory firm Biscayne and Juan Carlos Cortes, its co-founder, beneficial owner and CCO. The SEC alleged that Biscayne and Cortes failed to adopt procedures designed to prevent violations of the federal securities laws. The SEC noted that Cortes had no compliance training and that the firm used an "off-the-shelf" compliance manual that was purchased from a third party and was not tailored to the firm's needs.

   (b) To settle the SEC's claims, Cortes agreed, without admitting or denying the SEC's findings, to pay a penalty of $50,000.

4. Andrew Donohue, as SEC Chief of Staff in 2016, iterated his expectations of CCOs, stating, "I envision that the necessary expertise for compliance will consist of a far broader set of subjects, including expertise in technology, operations, market, risk, and auditing, to name a few. Even now, compliance personnel need to have a solid understanding of these areas, but I envision the role becoming even more demanding such that a CCO will truly need to be a jack of all trades with access to a wide array of skillsets."[41]

C. Cybersecurity

1. OCIE's 2016 examination priorities highlighted the SEC's interest in cybersecurity and stated, "In September 2015, we launched our second initiative to examine broker-dealers' and investment advisers' cybersecurity compliance and controls. In 2016, we will advance these efforts, which include testing and assessments of firms' implementation of procedures and controls."[42]

2. Cases:

   (a) *In the Matter of R.T. Jones Capital Equities Management, Inc.*, Admin. Proc. File No. 3-16827, Sept. 22, 2015

      (i) The SEC brought an enforcement action against R.T. Jones Capital Equities Management ("RT") alleging the firm violated Rule 30(a) of Regulation S-P, the "Safeguards Rule." From at least September 2009 to July 2013, RT stored sensitive personally identifiable information ("PII") of clients and others on its third-party-hosted web server. The firm's web server was hacked in July 2013 by a hacker who gained access and copy rights to

[40] *Available at* www.sec.gov/news/speech/keynote-address-2015-national-society-compliance-prof-cereseney.html.

[41] *Available at* www.sec.gov/news/speech/remarks-at-the-national-society-of-compliance-professionals-2016.html#_ftn1.

[42] Available at https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2016.pdf.

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the data on the server, leaving the PII vulnerable to theft. Although there was no indication that any of RT's clients suffered financial harm as a result of the cyberattack, the SEC instituted an enforcement action.

(ii) The SEC claimed that the firm failed to adopt written policies and procedures reasonably designed to protect customer data from anticipated threats or unauthorized access. For example, RT failed to conduct periodic risk assessments, implement a firewall, encrypt PII stored on its server or maintain a response plan for cybersecurity incidents. As part of the settlement, RT was censured and fined $75,000.

(b) *In the Matter of Morgan Stanley Smith Barney LLC*, Admin. Proc. File No. 3-17280, June 8, 2016.

(i) The SEC brought an enforcement action against Morgan Stanley Smith Barney ("MSSB") for alleging the firm violated Rule 30(a) of Regulation S-P, the Safeguards Rule. From 2011 to 2014, an employee of MSSB impermissibly accessed and transferred data, including PII, regarding approximately 730,000 customer accounts to his personal server, which was ultimately hacked by third parties. Those third parties posted portions of the stolen data to at least three Internet sites along with an offer to sell a larger quantity of stolen data in exchange for payment in a digital currency.

(ii) The SEC claimed that the firm's failure to adopt written policies and procedures reasonably designed to protect customer data caused a failure to protect customer information. As part of the settlement, MSSB was censured and fined $1 million.

(iii) Ceresney stated in the SEC press release announcing the settlement, "Given the dangers and impact of cyber breaches, data security is a critically important aspect of investor protection. We expect SEC registrants of all sizes to have policies and procedures that are reasonably designed to protect customer information."[43]

VII. MiFID II

A. 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 come into force on Jan. 3, 2018.

B. 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.

C. Key MiFID II reforms that are likely to have an effect on asset managers include:

1. *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

[43] *Available at* www.sec.gov/news/pressrelease/2016-112.html.

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the eligibility and due diligence requirements for direct electronic access and update the terms on which direct electronic access will be provided.

2. *Transparency Reforms*. MiFID II creates new transparency regimes for non-equity financial instruments, such as bonds, structured products and derivatives. EU managers that are MiFID firms transacting in financial instruments admitted to trading on an EU trading venue OTC (as is frequently the case with fixed income securities) will be required to publish post-trade transparency data through an Approved Publication Arrangement without the ability to rely on their sell-side counterparty to report the trade, except where such a counterparty is authorized as a "systematic internalizer."

3. *Trading Venues and SIs*. The existing pre-trade transparency waivers for equity instruments will be modified, which, among other things, will have an effect on 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 (i.e., a category of investment firms that deal on their own account with clients on a systematic basis) ("SI"). Managers should analyze the impact of the reforms on their trading strategies and engage with their EU trading counterparties to understand their status under MiFID II, and any changes to their terms of business or usual trading practices that may result from MiFID II.

4. *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.

5. *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 jurisdiction, even where the non-EU manager does not have a physical presence in their jurisdiction. The 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.

6. The so-called "third-country access" provisions in MiFID II create a new regime allowing non-EU managers to register with 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.

7. MiFID II includes a "reverse solicitation" exemption to these registration requirements (similar to the Alternative Investment Fund Managers Directive), but defined more narrowly.

8. *Best Execution.* MiFID II will require EU investment firms to publish information on their order execution policies and quality of execution obtained, including data on their top five execution venues or brokers for each category of financial instrument, including a breakdown of the trading volume by venue and analysis of specific factors that might impact on the firm's order execution choices (such as payments, discounts and rebates received). MiFID II also imposes an obligation on trading venues and SIs to publish data on execution quality and costs with a view to providing investment firms with data relevant to their choice of trading venue and their ability to meet their

best execution obligations. EU buy-side firms are understandably apprehensive about the potential impacts of publishing this information on their trading relationships. There is a possibility that the enhanced level of transparency applicable to both trading venues and investment firms will improve the level of competition on the sell-side, both in terms of price and quality of execution.

9. *Consolidated Tape Providers*. MiFID II has introduced two new concepts — that of a consolidated tape provider ("CTP") and approved publication arrangement ("APA"). MiFID II will require post-trade data to be submitted by SIs and investment firms trading OTC to an APA that will then be required to make the information available to the public on reasonable commercial basis in as close to real time as is technically possible. APAs must also be able to disseminate the information efficiently and consistently and in a way that ensures fast access and facilitates the consolidation of the information with similar data from other sources by CTPs.

10. The CTP regime requires CTPs to pick up the real-time data streams from trading venues and investment firms trading OTC in both equity and non-equity instruments, and to then consolidate the information into a continuous electronic data stream in a harmonized form and on a "reasonable commercial basis." CTPs are only able to vary fees according to objective, published criteria and for different categories of client. It is intended that these pricing differentials should account for the value that the market data represents to those customers — including whether it is used for trading activities, for re-sale or for data aggregation. A "reasonable commercial basis" for these purposes means that market data prices must be based on costs, including a "reasonable margin." There has not been a particular rush among data service providers to take on the role of a CTP. Concerns among data providers stem from the lack of certainty as to what "reasonable" fees they will be able to charge, as well as the fact that it is possible that multiple CTPs will be authorized, which will reduce potential economies of scale.

D. Market Abuse Enforcement in the EU

1. *Enforcement*. Recent enforcement actions have focused on insider dealing, improper disclosure of inside information, market manipulation and failure to report a suspicion of market abuse.

2. The Market Abuse Regulation ("MAR") took effect in EU member states on July 3, 2016. MAR sets out a regime of civil market abuse offences in relation to financial instruments admitted to trading on an EU trading venue. MAR has replaced the previous market abuse regime applicable in the EU under the Market Abuse Directive.

3. 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 market manipulation offence and a new offence of "attempted market manipulation"; (5) a new regime for reporting suspicious transactions and orders ("STORs") (which applies to buy-side firms, as well as sell-side firms in the EU); (6) a new framework for disclosures of inside information in the course of market soundings; (7) a new whistleblowing (to the regulator) and administrative sanctions regime; and (8) an introduction of a rebuttable presumption that cancelling or amending a pre-existing order once in receipt of inside information is insider dealing. Managers should update their market conduct policies to incorporate the new obligations under MAR, as relevant.

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E. Brexit

1. On June 23, 2016, the British public voted to leave the EU after 43 years of membership. The process for a member state exiting the EU is set out in Article 50 of the Treaty of the European Union. Article 50 prescribes that a member state that decides to withdraw must first formally notify the European Council ("Article 50 Notice"). Following the Article 50 Notice, the European Council will draw up the guidelines for the negotiations of the withdrawal agreement between the EU and the United Kingdom. Once negotiated, the withdrawal agreement must be adopted by a qualified majority of government ministers representing the remaining EU member states after obtaining consent of the European Parliament. The Article 50 Notice also sets a two-year period running, so that an eventual Brexit will occur at the earlier of: (1) the conclusion of the withdrawal agreement; or (2) two years following the Article 50 Notice.

2. Much of the U.K. financial services legislation, including the regulatory regime for asset managers, is derived from EU Directives. As an EU member state, the United Kingdom is also subject to a number of EU Regulations which have a direct effect in all member states. During the negotiation process, the United Kingdom will remain a member state of the EU and will continue to be bound by EU law (including the domestic legislation incorporating EU Directives).

3. Exactly how the future U.K. legal and regulatory landscape might be impacted by Brexit will only become clear once a formal approach to exit negotiations has been drawn up and the nature of the relationship that the United Kingdom will seek to maintain with the EU post-Brexit is known.

4. Two EU directives that shape the regulatory regime applicable to U.K. alternative asset managers are the Alternative Investment Fund Managers Directive ("AIFMD") and Markets in Financial Instruments Directive ("MiFID"). Both directives contain a passporting regime for cross-border services within the EU and establishment of branches in other member states based on the principle of common market access embedded in EU legislation. The AIFMD and, from 2018, MiFID II also include a so-called "third country" regime which gives access to EU markets to non-EU firms on the basis of an equivalence determination (that is, where such firms are subject to equivalent regulatory supervision in a non-EU jurisdiction).

5. If the Brexit negotiations result in the United Kingdom having continued access to the EU common market (and, accordingly, retention of the passporting rights), there will be no post-separation change for U.K. alternative investment managers. If U.K. managers lose passport rights as a result of Brexit, the United Kingdom may be in the position to secure a third-country equivalence status for the purposes of the third country passports. For example, if the Commission chooses to extend the so-called "third-country marketing passport" to alternative investment funds ("AIFs") established in the Cayman Islands and also agrees to grant U.K. (as the domicile of the manager) equivalence status, U.K. managers will have access to the third-country marketing passport for their Cayman AIFs in the same way as managers from other non-EU jurisdictions which may, in the future, be deemed "equivalent" by the Commission (e.g., U.S. managers marketing Cayman funds). Equally, if U.K. managers are deemed subject to equivalent supervision, they will be able to continue acting as AIFMs of Irish and Luxembourg AIFs.

6. It is unlikely that Brexit will have a direct impact on U.S. managers that do not have U.K.-based affiliates. U.S. managers who have registered their AIFs under the national private placement regime in the United Kingdom will be required to continue complying with its conditions, such as initial investor disclosures (e.g., an AIFMD disclosure supplement to the private placement memorandum), periodic reporting (including annual reports with remuneration disclosures) and Annex IV reporting. Depending on the terms of Brexit (i.e., whether it retains access to the common market), the United

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Kingdom may be in the position to relax its marketing restrictions in the future and revert to the pre-AIFMD marketing regime.

7. The ability of U.S. managers to provide portfolio management services to UCITS and AIFM platforms established in the remaining EU member states will depend, as now, on the local regulatory regime of the relevant EU member state (i.e., there will be no change).

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